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Table of contents

Executive summary

Executive summary 2

Africa

South Africa 7

Asia

China 21
Hong Kong (SAR) 37
India 47
Indonesia 59
Japan 67
Korea 75
Kuwait 85
Malaysia 89
Oman 99
Philippines 109
Saudi Arabia 117
Singapore 125
Thailand 137
Turkey 147
United Arab Emirates 157
Vietnam 161

Central and South America

Argentina 169
Brazil 179
Colombia 189
Costa Rica 199
Mexico 207
Panama 215
Uruguay 221
Venezuela 225

Europe

Austria	233	Luxembourg	391
Belgium	241	Malta	403
Bosnia and Herzegovina	251	Netherlands, The	413
Croatia	259	Norway	427
Cyprus	265	Poland	435
Czech Republic	271	Portugal	445
Denmark	279	Romania	457
Finland	289	Russia	463
France	297	Slovakia	475
Germany	313	Slovenia	485
Greece	331	Spain	491
Hungary	343	Sweden	505
Iceland	353	Switzerland	513
Ireland	361	Ukraine	525
Italy	375	United Kingdom	537
Jersey	385		

North America

Canada	547	United States	559

Oceania

Australia	579	New Zealand	595

Executive summary

Easing uncertainty boosts M&A worldwide

In the past year, the global economy turned the corner to solid growth. 2017 was the first year since the crisis that none of the 45 countries and jurisdictions monitored by the Organisation for Economic Co-operation and Development (OECD) were contracting. This tailwind of global growth has been supportive of M&A activity. The OECD's 13 March 2018 release of its global outlook showed an upward revision of global growth to 4.1 percent in 2018 and 4.0 percent in 2019. This optimistic forecast is reflected in almost all countries and jurisdictions, with developed markets seeing the greatest upward revisions.

In addition to economic momentum, several structural changes could pave the way for further M&A activity. The implications of US tax reform are becoming clearer. An outline of terms of Britain's exit from the European Union (EU) has been mostly resolved. Elections in countries like France, Germany and the Netherlands were won by parties that generally uphold the mainstream. The upcoming elections in Brazil is widely expected to have similarly positive outcomes for global markets.

As structural reforms and economic growth provide the backdrop, the performance of M&A markets is getting stronger across the world. Following a relatively sluggish 2016, M&As got off to a slow start in 2017 but gained momentum as the year unfolded. According to Mergermarket,[1] by the end of the year:

— North America saw almost 6,000 deals valued at 1.4 trillion US dollars (US$).

— With 7,235 deals, higher volumes of lower value European transactions amounted to US$929.3 billion.

— About 3,750 deals totaling US$673.5 billion took place in the Asia-Pacific region (except Japan), while over 450 deals in Japan totaled US$40.1 billion.

— Lower but nevertheless healthy deal volumes occurred in Latin America, with almost 600 deals worth US$80.4 billion, and the Middle East and Africa, with just over 400 deals worth US$59.4 billion.

— Globally, December 2017 alone saw five deals valued at almost US$200 billion.

— The energy, mining and utilities sector led the way globally in 2017 with deals valued at US$543.7 billion, followed by industrials and chemicals (US$395 billion) and consumer markets (US$380 billion).

Despite a correction in global markets early this year, M&A activity in 2018 could surpass 2017. Debt is expected to stay relatively inexpensive in the near term globally, and high accumulations of uninvested capital, or 'dry powder', are ready to be spent.

With a clearer idea now emerging as to the potential future impacts of Brexit, US tax reform and international tax changes from the Organisation for Economic Co-operation and Development's (OECD) base erosion and profit shifting (BEPS) project, private investors that have been taking a wait-and-see approach may begin moving in from the sidelines, emboldened by consistent growth to enter multiple large deals.

> "Private investors that have been taking a wait-and-see approach may begin moving in from the sidelines, emboldened by rising political stability and consistent growth to enter multiple large deals."

At the same time, strategic buyers are reviewing their mix of assets to help determine they are well positioned for the coming years. Strategic buyers are also seeing a surge of investor activism — a call to rationalize their asset mix through spin-offs and carve-outs of non-core assets outside the mainstream of the business.

With interest in disposing of assets generally rising among both private equity and strategic buyers and growing demand

[1] Mergermarket, *Monthly M&A Insider*, January 18, 2018, p 3–8.

from retail investors, interest in exits through initial public offerings may very well continue to climb.

Region by region, some of the more significant factors influencing the world's M&A markets are as follows.

North America

While re-negotiation of the North American Free Trade Agreement between **Canada**, the **United States** and **Mexico** continues to create uncertainty over future trade conditions, US tax reform is having a bigger, more immediate impact on M&A activity. The reform's US$1.3 trillion in tax cuts will undoubtedly free up cash that can drive domestic investment.

> "The reform's fundamental changes to the taxation of multinational entities could particularly affect planning for cross-border deals."

US tax reform's fundamental changes to the taxation of multinational entities could particularly affect planning for cross-border deals. The changes include a shift from a system of worldwide taxation with deferral to a hybrid territorial system, featuring a dividend exemption regime with current taxation of certain foreign income, a minimum tax on low-taxed foreign earnings, and new measures to deter base erosion and promote US production.

In particular, the dividend exemption regime could prompt companies with offshore cash reserves to repatriate these profits, and those companies may then look for new opportunities for investment closer to home. In addition, even though interest rates remain low, the new limit on the deductibility of interest expense to 30 percent of adjusted taxable income may cause some international companies to move debt out of the US to foreign jurisdictions.

Of course, such substantial reforms will create both winners and losers. Nevertheless, US tax reforms could drive significant M&A activity involving the US over the next few years. The longer-term impact is less certain, as many aspects of US tax reform will expire in 5 years unless further legislation is enacted to extend the time-limited changes.

Europe

Europe seems to have emerged from a period of political uncertainty in good shape, with projected economic growth of 2.4 percent in 2017,[2] the fastest in a decade, the European Commission says. Growth is expected to continue at 2.3 percent in 2018 and 2 percent in 2019.[3] Concerns that recent elections would produce waves of populist governments across Europe did not pan out. Markets in Europe and the UK have recovered from the initial shock of Brexit, and they seem to be proceeding with 'business as usual' as the Brexit negotiations continue.

> "Technology is propelling considerable M&A activity in Europe with consolidation in the technology sector itself and more technology buys from companies in traditional industries seeking to increase their performance."

Technology is propelling considerable M&A activity in Europe with consolidation in the technology sector itself and more technology buys from companies in traditional industries seeking to increase their performance. In some sectors, technology is increasingly entwined, as shown by recent activity in financial services (i.e. fintech) and healthcare.

The OECD's BEPS project and the European Union's (EU) ATAD 1 and 2 continue to alter the landscape for M&A in

[2] European Commission, Winter 2018 Economic Forecast.
[3] See note 4.

Europe and beyond. EU member states are required to transpose minimum rules under the ATAD into domestic law by 2019.

The BEPS changes restricting interest deductions based on a limit of 30 percent of earnings before income taxes, depreciation and amortization (EBIDTA) are among the changes having the biggest impact since these restrictions are new to many European countries and jurisdictions, including the **UK**, **Poland** and **Slovakia**.

Many European countries and jurisdictions were among the first 70 countries and jurisdictions to take part in the signing ceremony for the OECD's multilateral instrument (MLI) to combat treaty abuse in June 2017.[4] The MLI provides a vehicle for the swift implementation of the tax treaty-related measures for hybrid mismatches, treaty shopping, permanent establishments and mutual agreement procedures.

> "Attention to the new risks from BEPS-driven tax changes is especially important when completing tax due diligence reviews, defining tax indemnities, and undertaking acquisition integration planning."

These changes could significantly affect cross-border M&A planning, structuring and financing in Europe and other regions. Attention to the new risks from BEPS-driven tax changes is especially important when completing tax due diligence reviews, defining tax indemnities, and undertaking acquisition integration planning.

Latin America

Following the boom years of the recent past, countries and jurisdictions in this region have been establishing a firmer foundation for businesses and investing in their longer-term success. The diversity of tax regimes in the region creates varying conditions for foreign investment:

— **Brazil's** upcoming election and stabilizing currency are helping to boost investor confidence and as a result the M&A market is rebounding.

— **Argentina's** new government is making progress on structural reforms that are likely to attract foreign direct investment. These reforms include opening the previously state-dominated airline industry to competition, comprehensive tax reform, curbing subsidies on gas, electricity and transportation, enacting fiscal discipline, and reforming the judiciary.

— **Peru** and **Colombia** are attracting interest from private equity, particularly in the energy sector. **Colombia** introduced a major tax reform in January 2017 that, among other things, eases and simplifies corporation taxation while also addressing tax evasion.

— With corporate tax hikes and increasingly complex anti-avoidance rules, **Chile's** recent tax changes have to some extent bucked international trends, but the country's strong social and political stability continues to attract investors.

— The tax-friendly countries and jurisdictions of Central America remain viable, including **Costa Rica** despite its rising labor costs.

Asia-Pacific region

In the Asia-Pacific region, the near-term outlook is generally positive with adequate surplus capital and conditions for executing transactions getting easier. Like Latin America, however, the cross-border M&A climate in the Asia Pacific is mixed:

— Ongoing tax reforms in **Australia** continue to dampen the M&A environment. These reforms include a diverted profits tax that took effect in July 2017, increased withholding taxes on capital gains of non-residents selling certain Australian real property, and more capital gains tax changes affecting 'look-through' earn-out arrangements.

— Outbound investment from **China** in specific sectors has slowed in the past year under a stated government policy as worries that rising amounts of capital outflows have led to tighter foreign investment controls.

— **Japan's** corporate tax rate has been steadily dropping to a current effective rate of about 30 percent (see Japan commentary at page 67). The lost tax revenues are being recouped through various measures, such as new limits on loss carryovers and scheduled increases to its consumption tax rate (from 5 percent in 2014 to 8 percent currently and 10 percent in 2019) (see page 67). Corporate tax rates have also dropped in **Malaysia** and **Vietnam**.

— **Hong Kong (SAR)** proposed to extend its profits tax exemption for offshore investment funds to onshore privately offered open-ended fund companies. It has also introduced a two-tiered profits tax regime that sees the tax rate for the first 2 million Hong Kong dollars (HKD) of profits reduced to half of the standard profits tax rate (see Hong Kong (SAR) commentary at page 40).

[4] OECD, Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS.

Technology accelerates tax due diligence reviews

The far-ranging impacts of current and potential future US, international and other tax reforms are complicating efforts of sellers to demonstrate full tax compliance to potential buyers and of potential buyers to conduct thorough due diligence regarding their targets' tax affairs. With so many tax changes coming on stream, planning the tax-related details and clauses of legal agreements in advance is crucial to mitigate tax consequences, with special attention to clauses referring to price, contingent prices, liabilities, indemnification and warranties.

> "Brazil is leading a trend among tax and regulatory authorities worldwide to require electronic access to taxpayers' digital records and accounts, and Latin American dealmakers have been among the first to deploy this technology in the M&A space."

Brazil is leading a trend among tax and regulatory authorities worldwide to require electronic access to taxpayers' digital records and accounts, and Latin American dealmakers have been among the first to deploy this technology in the M&A space. Advanced data and analytics and artificial intelligence are transforming due diligence processes. As compliance-driven automation and standardization enables richer data and more powerful analytic results, due diligence teams can take a deeper dive into the tax affairs of targets more quickly, potentially shortening the deal-making process and enabling better decisions.

However, many sellers are reluctant to offer this level of openness, with sellers in the US generally showing less comfort than their counterparts in Europe and the Asia Pacific region. As the use of data and analytics in M&A becomes more entrenched over the next 3 to 5 years, sellers in all parts of the world could be compelled to become more transparent.

On the buy side, early adopters of data and analytics could gain a significant competitive advantage, while those who delay may risk losing out as they struggle to catch up. Technology is also changing the composition of M&A teams, as data and analytic skills become an increasingly important part of the talent mix.

Long-term outlook

While the short-term outlook for global M&A is seemingly bright, some clouds on the horizon could alter the situation in the longer term. Many US tax reform measures will expire in 5 years. With a US presidential election coming in 2020 and Congressional elections in 2018, 2020, and 2022, whether these measures will be extended is unknown. If China continues to shift its global activities, the long-term implications are unclear. International tax rules should generally remain somewhat stable for 2018, but this may very well change in 2019 and 2020 as the minimum standards agreed by countries and jurisdictions taking part in the OECD BEPS project begin to take effect.

> "The current period of stability has M&A tax professionals with KPMG's members firms optimistic that M&A deal volumes will continue to increase, at least for the remainder of 2018."

In summary, M&A activity is on the rebound worldwide as synchronized global growth combined with rapid technological change spur a realigning of strategic objectives. While the outlook is hazier 3 to 5 years out, the current period of stability has M&A tax professionals with KPMG's members firms optimistic that M&A deal volumes will continue to increase, at least for the remainder of 2018. How long the current buoyancy will continue remains to be seen. For now it seems the time to 'wait and see' is over, and buyers and sellers have at least a limited window to make hay while the sun shines.

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South Africa

Introduction

The environment for mergers and acquisitions (M&A) in South Africa is far less clement than in previous years due to political and economic uncertainty. These constraints have reduced the economy's growth and led to a decrease in M&A activity. Ratings downgrades have also led to concerns about the adverse effects of rising financing costs on the M&A environment.

Recent developments

The latest tax amendment cycle has seen significant changes to the taxation of extraordinary dividends, along with a clampdown on schemes designed to facilitate distributions to non-resident shareholders free of dividend withholding tax (WHT).

Tax-exempt and dividend WHT-exempt dividends exceeding 15 percent of the market value of the shares and declared within 18 months before the shares' disposition are subject to either income tax or capital gains tax (CGT) where certain minimum shareholding thresholds are met (10 percent for listed entities, 50 percent for unlisted entities, and 20 percent for unlisted entities where no shareholder holds a majority interest).

Dividends paid to non-residents are subject to dividend WHT at a rate of 20 percent (unless reduced under tax treaty). By contrast, the return of so-called contributed tax capital (CTC) — generally, the share capital and share premium of a company — is not subject to tax for the non-resident. Legislation has now been introduced to curb schemes that seek to inflate the CTC available for distribution.

These changes significantly limited the ability of sellers to exit a South African investment through a share buy-back mechanism. In addition, the new extraordinary dividend regime may adversely affect the ability of companies to restructure using the so-called 'rollover relief' provisions (which broadly allow companies to transfer assets in a tax-neutral manner; see 'Crystallization of tax charges' below).

Key tax provisions

Withholding taxes

Withholding tax on interest

As of 1 March 2015, a 15 percent WHT is imposed on interest received by or accrued to a non-resident (that is not a controlled foreign company — CFC). An exemption applies for any amount of interest received by or accrued to a non-resident in respect of:

— government debt instruments

— listed debt instruments

— debt owed by a bank, the South African Reserve Bank (SARB), the Development Bank of South Africa (DBSA) or the Industrial Development Corporation (IDC)

— debt owed by a foreign person or a headquarter company.

South Africa is in the process of renegotiating its existing tax treaties in light of the new 15 percent WHT on interest.

Withholding tax on dividends

A WHT on dividends applies regarding all dividends declared and paid to non-residents on or after 1 April 2012. The dividend WHT is levied at a rate of 20 percent (increased from 15 percent as of 22 February 2017), subject to treaty relief.

Withholding tax on royalties

Royalties paid by a South African entity to a non-resident are subject to a WHT of 15 percent as of 1 January 2015.

Deductibility of interest on debt used to acquire equity

As of 1 January 2013, interest incurred on debt to finance the acquisition of the shares is deductible for tax purposes, where a South African company acquires at least a 70 percent equity shareholding in another South African operating company. An 'operating company' includes any company that carries on business continuously by providing goods or services for consideration. The provisions require at least 80 percent of the receipts and accruals of the operating company to be 'income', that is, non-exempt amounts. Where the shares in the operating company are acquired indirectly through the acquisition of shares in a controlling company, the interest is

deductible only to the extent that the value of the controlling company shares is attributable to the operating company; the deduction may also be limited under the interest limitation rules discussed below.

Interest deductibility for M&A transactions

Previously, interest on debt used to fund certain transactions (discussed below) was not automatically deductible. Approval from the South African Revenue Service (SARS) was needed.

This approval process has been replaced by section 23N, which essentially limits the deductibility of interest where debt is used:

- to fund the acquisition of a business or assets from a related group entity on a tax-neutral basis
- to fund at least a 70 percent equity shareholding in a South African operating company.

In these cases, the amount of interest deductible in the year of the transaction and the following 5 years cannot exceed:

- the sum of:
  - interest received
  - a formula-based percentage of 'adjusted taxable income' (which is essentially the company's earnings before interest, tax, depreciation and amortization (EBITDA)). The percentage of the adjusted taxable income varies based on the average South African repo rate during the year of assessment and is limited to a maximum of 60 percent.
- less:
  - the amount of interest incurred on debts not falling within the section.

These rules apply to transactions entered into on or after 1 April 2014, and also to the refinancing of transactions that were subject to the earlier pre-approval process discussed above.

Where such interest is disallowed, the disallowed portion of interest is lost and cannot be carried forward.

Limitations on interest paid to non-residents

As of 1 January 2015, section 23M imposes a general limitation on interest deductions where payments are made to offshore investors (i.e. creditors) or local investors who are not subject to either income tax or interest WHT in South Africa and who are in a controlling relationship with a South African resident debtor.

The limitations also will apply between a debtor and creditor who are not in a controlling relationship where a creditor advances funding to the debtor and the funding was obtained from a non-resident person in a controlling relationship with the debtor (i.e. back-to-back funding).

Essentially, where section 23M applies, the interest deduction by the debtor cannot exceed:

- the sum of:
  - interest received
  - a formula-based percentage of 'adjusted taxable income' (essentially, EBITDA). The percentage of the adjusted taxable income varies based on the average South African repo rate during the year of assessment and is limited to a maximum of 60 percent.
- less:
  - interest incurred on debts other than debts falling within section 23M (where the interest falls within both section 23M and section 23N, the portion of interest disallowed under section 23N is excluded from the calculation).

Any interest disallowed under section 23M may be carried forward to the following year of assessment and deemed as interest incurred in that year.

The provisions do not apply where the creditor funded the debt advanced to the debtor with funding granted by an unconnected lending institution and the interest charged on the loan does not exceed the official rate of interest for purposes of the Income Tax Act plus 100 basis points.

Asset purchase or share purchase

The following sections address those issues that should be considered when contemplating the purchase of either assets or shares. The pros and cons of each option are summarized at the end of this report.

Purchase of assets

The decision of whether to acquire the assets of a business or its shares depends on the details of the transaction. The advantages and disadvantages of both purchase mechanisms need to be understood in order to effect the acquisition efficiently while complying with legislative requirements.

Asset purchases may be favored due to the interest deductibility of funding costs and the ability to depreciate the purchase price for tax purposes. However, other considerations may make an asset purchase far less favorable, including, among other things, an increased capital outlay, legislation that may disallow the deduction of interest (discussed above), the inability to use the tax losses of the target company, and the inability to deduct or recover VAT

on irrecoverable debts (unless the debts are acquired on a recourse basis).

Purchase price

Where assets (versus shares) are disposed of, the purchase price must be allocated between the assets acquired in terms of the sale agreement on a reasonable and commercial basis. This allocation is required to determine the tax implications on the disposal of each individual asset.

When assets are purchased at a discount, no statutory rules stipulate how to allocate the purchase price among the assets. Unless the discount can be reasonably attributed to a particular class of asset, it should be allocated among all the assets on some reasonable basis.

Withholding tax on immovable property disposals

A WHT is applicable to the disposal of immovable property by a non-resident to any other person insofar as the immovable property or a right or interest therein (i.e. including an interest of at least 20 percent in a company where at least 80 percent of the market value of the company's shares is attributable directly or indirectly to immovable property, other than trading stock) is situated in South Africa, subject to certain exemptions.

In these cases, the buyer must withhold 7.5 percent of the purchase price where the seller is a natural person, 10 percent if the seller is a company and 15 percent if the seller is a trust.

The buyer is required to pay the WHT to SARS within 14 days from the date of withholding.

Where the buyer is not a resident of South Africa, the time period for payment is extended to 28 days. If the amount is withheld from consideration payable in a foreign currency, the amount must be converted into South African rand (ZAR) at the spot rate on the date that the amount is paid to SARS.

Where the seller does not submit a tax return in respect of the applicable year of assessment within 12 months after the end of the year of assessment, the WHT is deemed to be a self-assessed final tax.

Goodwill

No provision exists for the write-off of goodwill for tax purposes by the buyer. Accordingly, care should be taken to allocate the purchase price, as much as possible, among the tangible assets, providing such allocations do not result in the over-valuation of any asset.

Allowances/deductions

Certain allowances or deductions may be allowed on certain assets purchased by the taxpayer. When the assets are re-sold, the potential recoupment of allowances or deductions previously claimed on these assets should be considered. If a recoupment arises, this amount is required to be added back to the taxpayer's taxable income.

Tax attributes

Tax losses cannot be passed on to the buyer of a business. Recoupments in the company (i.e. the difference between proceeds and tax value) are taxable to the seller where the values of certain assets realized exceed their tax values.

Crystallization of tax charges

South African income tax legislation provides for rollover relief on intragroup transfers of assets if certain requirements are met. For example, the rollover is available where assets are transferred within a 'group of companies', typically companies with a 70 percent common shareholding. Each of the intragroup provisions contains its own specific anti-avoidance provisions, which deem the buyer to dispose of and immediately reacquire the assets at their market value on the day that certain events occur. Essentially, the buyer becomes liable for all of the tax that was deferred and effectively rolled over in the intragroup transfer.

Consequently, the buyer should satisfy itself that it has been made aware of all prior intragroup transfers of the assets that it acquires.

Value added tax

When certain intergroup income tax relief provisions apply to a transaction, the supplier and recipient are deemed to be one and the same person for value added tax (VAT) purposes. This implies that there is no supply for VAT purposes, provided both the supplier and recipient are registered as sellers for VAT purposes; in certain cases, the supply must be that of a going concern.

Assets or liabilities excluded from the income tax relief provisions are considered separately from a VAT perspective to determine the applicable rate of VAT to be levied, if any.

Where the income tax and VAT relief provisions are applied, it was previously argued that sellers may not be entitled to recover VAT on the costs incurred on the transaction because the VAT was not incurred for the purpose of making taxable supplies. However, the SARS Draft Interpretation Note, issued 31 March 2009, states that even though a transaction may not be regarded as a supply for VAT purposes, the VAT incurred on goods and services acquired for the purpose of making the supply may still qualify as input tax for VAT purposes. The test is whether the seller would be entitled to an input tax deduction when section 8(25) of the VAT Act does not apply. If the answer is yes, input tax can still be claimed.

Where this group relief provision does not apply and a business, or part of a business that is capable of separate operation, is sold as a going concern, VAT is payable at zero

rate (i.e. charged with VAT but at 0 percent). To qualify for zero rating, both the seller and the buyer must be registered for VAT and agree in writing that:

— the business will be sold as a going concern

— the business will be an income-earning activity on the date of transfer

— the assets needed to carry on such enterprise will be sold by the supplier to the recipient

— the price stated is inclusive of zero rate VAT.

The contract can provide that, should the zero rating for some reason not apply, VAT at the standard rate would be added to the selling price.

Transfer taxes

Transfer duty is payable by the buyer on the transfer of immovable property to the extent the sale is not subject to VAT.

A notional VAT input credit is available to a seller on the purchase of secondhand property from a person not registered for VAT. Where secondhand goods consisting of fixed property are acquired wholly for the purposes of making taxable supplies, the input tax claimable is calculated as the tax fraction of the lesser of any consideration in money given by the seller or the open market value. The notional input tax is claimable in the tax period that registration of the fixed property was affected in the deeds registry in the name of the seller.

Under the Transfer Duty Act, the transfer duty is payable on the value of the property at the following rates (for natural persons and persons other than natural persons):

— on the first ZAR900,000 — 0 percent

— from ZAR900,001 to ZAR1,250,000 — 3 percent of the property value above ZAR750,000

— from ZAR1,250,001 to ZAR1,750,000 — ZAR15,000 plus 6 percent of the value above ZAR1,250,000

— from ZAR1,750,001 to ZAR2,250,000 ZAR45,000 plus 8 percent of the amounts above ZAR1,7500,000

— from ZAR2,250,001 to ZAR10 million — ZAR85,000 plus 11 percent of the value above ZAR2,250,000

— above ZAR10 million — ZAR937,500 plus 13 percent of the value in excess of ZAR10,000,000.

Purchase of shares

Share purchases are often favored because of their lower capital outlay and the buyer's ability to benefit from the acquisition of any tax losses of the target company (subject to the rules governing the carry forward of assessed losses).

However, the inability to deduct the funding costs associated with the acquisition (except in limited circumstances as discussed above) is a significant barrier to this method.

Due diligence reviews

It is not unusual for the seller in a negotiated acquisition to open the books of the target company for a due diligence review by the prospective buyer, which would generally encompass an in-depth review of the target's financial, legal and tax affairs by the buyer's advisors. The findings of a due diligence review may result in adjustments to the proposed purchase price and the inclusion of specific warranties negotiated between the buyer and seller in the sale agreement.

Tax indemnities/warranties

The buyer generally requires warranties from the seller regarding any undisclosed taxation liabilities of the target company. The extent of the warranties is a matter for negotiation.

Tax losses

Tax losses may be retained by the buyer when the shares are purchased, unless any anti-avoidance rules apply.

Securities transfer tax

Securities transfer tax (STT) is levied on every transfer of a security and was implemented from 1 July 2008 under the Securities Transfer Tax Act, No. 25 of 2007 (the STT Act), together with the Securities Transfer Tax Administration Act, No. 26 of 2007.

The STT Act defines 'transfer' to include the transfer, sale, assignment, cession or disposal in any other manner of securities, or the cancellation or redemption of securities. STT is not payable on the issue of securities. Only transfers that result in a change in beneficial ownership attract STT.

A security means any share or depository in a company or a member's interest in a close corporation. STT applies to the purchase and transfers of listed and unlisted securities.

STT is levied for:

— every transfer of any security issued by:

  — a close corporation or company incorporated, established or formed inside South Africa, or

  — a company incorporated, established or formed outside South Africa and listed on an exchange, and

— any reallocation of securities from a member's bank restricted stock account or a member's unrestricted and security restricted stock account to a member's general restricted stock account.

STT is levied at the rate of 0.25 percent of the taxable amount (according to a prescribed formula that differs depending on whether the securities are listed).

Value added tax

The supply of shares by the owner of the shares is an exempt supply for VAT purposes. Any VAT incurred on the acquisition of any goods or services for the purposes of the exempt supply is not recoverable as input tax.

Capital gains tax

Non-residents are subject to CGT only on capital gains from the disposal of certain South African property, including immovable property, an interest in such immovable property (i.e. an interest of at least 20 percent in a company where at least 80 percent of the market value of the company's shares is attributable directly or indirectly to immovable property, other than trading stock), and business assets attributable to a permanent establishment situated in South Africa. However, in line with international practice and South African tax treaties, non-residents are not liable to CGT on other assets, such as shares they own in a South African company, unless the value of the assets is attributable to immovable property situated in South Africa (this varies depending on the treaty).

Choice of acquisition vehicle

A number of options are available to a foreign buyer when deciding how to structure the acquisition of a local resident company. The Income Tax Act contains special rules for asset-for-share transactions, amalgamation transactions, intragroup transactions, unbundling transactions and liquidation distributions.

These provisions aim to facilitate mergers, acquisitions and restructurings in a tax-neutral manner. The rules are very specific and generally do not apply when one of the entities in the transaction is not a company.

Often the most crucial element to consider when choosing the vehicle is whether to structure the acquisition through a branch or a subsidiary. While the VAT implications of the branch and a subsidiary structure are the same, the income tax implications do differ.

Local intermediary holding company

The incorporation of a South African intermediary holding company affords limited liability protection. The intermediary holding company may invest in various joint ventures separately rather than through one single entity. Dividends received by the intermediary company are exempt from dividend WHT, allowing funds to be pooled at the intermediary level for re-investment or distribution.

Additional administrative and regulatory costs incurred by the intermediary holding company may not be tax-deductible because the intermediary earns no taxable income. In certain instances, any expenditure incurred by the intermediary company may have to be apportioned by taking into account the nature of its income streams (if any).

Foreign parent company

There are generally no legal restrictions on the percentage of foreign shareholding in a South African incorporated company. Payments of royalties, dividends or interest on loans are subject to the WHT regimes (as discussed above) and to transfer pricing and thin capitalization rules.

Where these structures are implemented, it is important to consider the potential VAT implications for the foreign parent company. For example, SARS is of the view that the granting of licenses, etc., constitutes the carrying on of an enterprise by the foreign parent, so the foreign parent should be VAT-registered. However, the Revenue Authority grants rulings in some cases absolving the foreign parent from VAT registration.

Non-resident intermediate holding company

The foreign intermediary may separately invest into various African countries and may also be subject to foreign domestic anti-avoidance legislation, such as CFC legislation. The intermediary would need to be established in a jurisdiction that has lower rates of WHT on dividends, interest and royalties than those stipulated in the relevant tax treaties.

Any dividends declared to the foreign intermediary are subject to dividend WHT, which may be reduced by a tax treaty.

External company/branch

If a foreign company has engaged or is engaging in a course of conduct or a pattern of activities in South Africa over a period of 6 months that would lead a person to reasonably conclude that such foreign company intended to continually engage in business in South Africa or if it is a party to one or more employment contracts in South Africa, then it is required to be registered as an external company with the Companies and Intellectual Property Commission (CIPC) in South Africa. An external company is often referred to as a 'branch'.

Once registered, the external company/branch must maintain an office in South Africa, register its address with the CIPC and submit annual returns. It is not subject to the audit or review requirements of the Companies Act, 71 of 2008 (Companies Act).

Where a group company purchases the assets of a South African business, it may operate the business in South Africa either in an external company or in a private company established as a local subsidiary company in South Africa.

The South African income tax system is based on taxable income. 'Taxable income' is gross income (non-capital) received by or accrued to a resident taxpayer, less any exempt income and less all allowable expenditure actually incurred in the production of that income. Non-residents are taxed on a source basis.

Both a local subsidiary (i.e. a private company in which shares are held by the foreign company) and external company/branch are subject to a 28 percent tax rate. Branch profits are not subject to any WHT on their remittance to the foreign 'head office'.

Resident companies are, however, subject to dividend WHT. As an external company/branch is not a separate entity, expenditure payable to its foreign head office for royalties, management fees and interest on loans is generally not tax-deductible in South Africa.

The Income Tax Act does provide for the deduction of expenditure and losses actually incurred outside South Africa in the production of income, provided they are not of a capital nature. Where the foreign company incurs expenditure outside of South Africa in the production of the South African branch's income, such amounts normally are tax-deductible by the external company/branch. The amount of the deduction is the actual amount of expenditure incurred outside South Africa, which may not equate to the market value of the goods or services in South Africa.

The tax rates in the foreign country versus the tax rates in South Africa are an important factor in deciding whether a local subsidiary or a local branch of a foreign company would be more favorable from a tax point of view, especially as external companies/branches are not subject to dividend WHT.

An advantage of external companies/branches is that, where more than one external company/branch in the group operates in South Africa, the losses of one external company/ branch may be offset against the taxable income of another external company/branch in determining the South African income tax payable. This setting-off of losses is not allowed for companies.

Domesticated company

A foreign company may apply to transfer its registration to the South Africa from the foreign jurisdiction in which it is registered, provided that it complies with the requirements set out in the Companies Act. Such a company is referred to as a 'domesticated company'. A domesticated company becomes subject to the Companies Act on transfer of its registration.

Joint venture

When acquisitions are to be made together with other parties, the choice of an appropriate vehicle is important. Generally, such ventures can be conducted through partnerships, trusts or companies. While partnerships are ideally suited for joint ventures, the lack of limited liability, the joint and several liabilities for debts, and the lack of separate legal existence limit their use. When a partnership is used, its taxable income is first determined and then apportioned between the partners in accordance with their respective interests.

From a VAT perspective, these unincorporated bodies of persons are deemed to be persons separate from their underlying partners/members, which can create separate VAT registration liabilities. When using such a vehicle, it is important to set it up properly from a VAT perspective to avoid irrecoverable VAT costs.

Choice of acquisition funding

The tax treatment of interest and dividends plays an important role in the choice between debt and equity funding. A hybrid instrument, which combines the characteristics of both debt and equity, may also be used to finance the purchase.

Debt

An important advantage of debt over equity is the greater flexibility it provides. Debt can be introduced from any company within a group, a financial institution or any other third party. In addition, debt can be varied as a group's funding requirements change, whereas any change in equity, particularly a decrease, can be a complex procedure.

Further, subject to the interest limitation provisions noted above and South African transfer pricing and thin capitalization provisions, the use of debt may increase an investor's return and thus be preferable to an equity contribution.

Deductibility of interest — foreign company

When funds in South Africa are loaned to a borrower, the interest earned by the lender, being from a South African source, is usually tax-exempt, provided certain requirements are met. The interest is subject to a WHT of 15 percent as of 1 January 2015, subject to relief under a tax treaty. Interest on foreign loan funding can be remitted abroad, provided the SARB has previously approved the loan facility, including (among others) the repayment terms and the interest rate charged.

Approval from the SARB or the authorized dealer (as the case may be) must be obtained by the South African exchange control resident before any foreign financial assistance may be accepted. This requirement is intended to ensure that the repayment and servicing of loans do not disrupt the balance of payments. For loans, this entails providing full details of the loan to be received, the purpose of the loan, the repayment profile, details of all finance charges, the denomination of the loan and the rate of

interest to be charged. The loan itself does not need to be approved by the SARB for the funds to flow into South Africa, but, as already noted, the non-approval of the loan may result in restrictions on the repayment of the loan, any interest thereon and any disinvestment from South Africa.

The SARB usually accepts an interest rate that does not exceed the prime lending rate in South Africa when the loan is denominated in ZAR. Where the loan is denominated in foreign currency, the SARB accepts a rate that does not exceed the relevant interbank rate plus two basis points.

The South African transfer pricing provisions should be considered where loan proceeds are provided by a non-resident creditor (as discussed above). Additionally, under legislative proposals having effect from 1 January 2015, where a debtor incurs interest on a debt provided by a creditor that is not taxable in South Africa and these parties are connected with each other, then the interest incurred by the debtor may be limited in relation to that debt. This limitation is determined with reference to the debtor's adjusted taxable income. Any portion of the non-deductible interest may be carried over to the following year of assessment.

Debt waivers

Where a debt is subject to a concession or compromise (e.g. through a debt waiver, change in terms or conditions, or an issue of shares with a market value less than the loan's face value), a 'debt benefit' can result. The amount of any debt benefit is added to income and subject to tax at 28 percent to the extent that the debt has funded tax-deductible expenditure. To the extent that the debt has funded the acquisition of capital assets, the tax cost of the assets is reduced by the amount of the debt benefit. If the asset was disposed of before the debt benefit arose, any capital loss available to the company is reduced by the reduction amount.

Where the debt resulted from the supply of good or services, VAT input tax clawbacks should be considered.

Equity

A buyer may use equity to fund its acquisition by issuing shares to the seller as consideration or by raising funds through a seller placing.

Share issues are not subject to STT. However, dividends paid by a South African company are not deductible for South African tax purposes.

Previously, the South African thin capitalization provisions applied where financial assistance granted by a connected person that was a non-resident or a non-resident that held at least 25 percent of the equity shares capital/voting rights in a South African company exceeded a 3:1 debt-to-fixed-capital ratio (calculated with reference to the proportion of equity held). If so, the excessive portion of interest was disallowed as a deduction from the taxable income of that South African company.

As of 1 April 2012, thin capitalization is now treated as part of the general transfer pricing provisions. This test no longer applies a debt-to-fixed-capital ratio. Rather, it is necessary to analyze whether the financial assistance granted is excessive in relation to financial assistance that would have been granted had the investor and the connected person been independent persons' dealing at arm's length. These changes are intended to be compatible with the Organisation for Economic Co-operation and Development (OECD) guidelines.

Non-tax reasons may exist for preferring equity, for example, where a low debt-to-equity ratio is favored. This factor is often the reason for companies choosing hybrid funding.

Hybrids

Dividends declared from hybrid equity instruments are deemed to be income and taxable as such. Where dividends or capital returns on the shares are hedged by a third party, the dividends declared on these shares may be deemed to be taxable (subject to certain exemptions). Otherwise, the normal tax principles relating to debt and equity apply. The provisions of the Banks Act, which regulates the issue of commercial paper, and the Companies Act, which regulates offers to the public, may need to be considered.

In certain circumstances, interest on hybrid debt instruments (i.e. debt with equity-like characteristics) may be deemed to be dividends paid (and thus not deductible for the payer).

Discounted securities

The tax treatment of securities issued at a discount normally follows the accounting treatment. As a result, the issuer should be able to obtain a tax deduction for the discount accruing over the life of the security, provided the discount amounts to 'interest' for tax purposes. Similarly, the holder of the instrument may be subject to tax on the discount received over the life of the security.

Deferred settlement

The period or method of payment generally does not influence the tax nature of the proceeds. The payment for a capital asset can be deferred without altering the capital nature of the proceeds. However, where the full selling price is not clearly stipulated and payment is based on a proportion of profits, an inherently capital transaction may be treated as revenue and taxed in the seller's hands. Likewise, care should be taken not to have the sale proceeds characterized as an annuity, which is specifically taxable in South Africa.

Share swaps

Approval from the exchange control authorities is required for the exchange of shares in cross-border mergers and amalgamations and for issues of shares on acquisition of

assets. To obtain this approval, the assets and shares must be valued.

When shares are issued in exchange for an asset, South African legislation deems the value of the shares issued to equal the market value of the asset acquired. Moreover, the issuing company is deemed to acquire the asset at the market value of the shares immediately after the acquisition.

Other considerations

Concerns of the seller

The concerns of a seller may vary depending on whether the acquisition took place via shares or via a purchase of assets. When the assets are acquired by the buyer, for example, CGT may be levied on the capital gain realized on the disposal of the assets. Further, to the extent that any deductions were claimed against the original cost of the assets and the amount realized from the sale of the assets exceeds the tax values thereof, the seller may experience clawbacks, which it would have to include in its gross income (as defined) and would be subject to income tax at the normal rate of 28 percent.

When the seller does not receive adequate consideration for the disposal of its assets, the transaction may be subject to donations tax at the rate of 20 percent on the difference between the consideration actually given and the market value consideration.

The sale of shares also may be subject to CGT, assuming the shares were held by the seller on capital account. To the extent that the seller disposed of the shares in a profit-making scheme, the proceeds may be taxed on revenue account at a rate higher than the rate of CGT. However, the 3-year holding rule in the South African Income Tax Act would deem the proceeds received on the sale of shares held continuously for 3 years to be capital in nature and thus taxable at the effective capital gains tax rate of 22.4 percent (assuming the seller is a company).

Concerns of the buyer

To the extent that the assets are disposed of, the assessed tax losses of the seller cannot be carried forward into the new company, so the losses would be ring-fenced in the seller and thus lost.

When the seller decides to dispose of shares, the tax losses in the company remain in the company, available for future set-off. However, where the SARS is satisfied that the sale was entered into for the purpose of using the assessed loss and that, as a result of the sale, income has been introduced into the company to use the loss, the set-off of the loss may be disallowed.

Group relief/consolidation

South Africa's tax law does not recognize the concept of group taxation, where losses made by some group companies are offset against profits made by other group companies. Rather, companies are assessed as separate entities. However, intragroup transactions may take place in a tax-neutral manner in certain circumstances, mostly where companies form part of the same South African group of companies (unless the foreign company has a place of effective management in South Africa). For companies to be considered as part of a group, these companies are required to have a common shareholding of at least 70 percent of their equity share capital.

Transfer pricing

The overriding principle of the transfer pricing legislation is that cross-border transactions between connected persons must be conducted at arm's length.

Under the Income Tax Act, where connected persons conclude a cross-border transaction, operation, scheme, agreement or understanding (e.g. grant or assignment of any right, including a royalty agreement, provision of technical, financial or administrative services, and financial assistance such as a loan) that does not satisfy the arm's length principle and a tax benefit results for one party to the agreement, the price must be adjusted to reflect an arm's length price in determining the taxable incomes of the persons involved.

Essentially, the focus is on the overall arrangements and the profits derived from them. If terms or conditions differ from the terms and conditions that would exist between independent persons acting at arm's length and the difference confers a South African tax benefit on one of the parties, the taxable income of the parties that have benefited must be calculated as if the terms and conditions had been at arm's length. In addition, the difference is deemed to be a dividend in specie, subject to dividend WHT at 20 percent.

The transfer pricing provisions also cover any financial assistance (i.e. debt, security or guarantee) granted between connected persons. As such, the previous legislation pertaining to thin capitalization is replaced with this arm's length test. Thus, for example, a taxpayer should ensure that the interest rate on an intragroup loan is at arm's length and the taxpayer must demonstrate that the amount borrowed is also at arm's length.

At 20 percent, the threshold for determining whether two persons are considered as connected persons, particularly related to financial assistance, is relatively low compared to global standards.

Foreign investments of a local target company

South Africa's CFC legislation is designed to prevent South African companies from accumulating profits offshore in low-tax countries.

When a South African resident directly or indirectly holds shares or voting rights in a foreign company, the net income

of that company is attributed to the South African resident if that foreign company is a CFC and does not qualify for any of the available exclusions. The net income of a CFC attributable to the South African resident is the taxable income of the CFC, calculated as if that CFC were a South African taxpayer and resident for specific sections of the Income Tax Act. Consequently, both income and capital gains are attributed.

The main exemptions to these rules are the foreign business establishment (FBE) exemption and the so-called 'high-tax jurisdiction exemption' (i.e. where the CFC would be subject to tax in that foreign jurisdiction at a rate of at least 21 percent). Where a CFC's income and gains are attributable to an FBE (including gains from the disposal or deemed disposal of any assets forming part of that FBE), they are generally not attributed to the South African-resident parent, subject to the application of diversionary rules and a mobile passive income test.

Company law

The Companies Act regulates companies and external companies that are incorporated in South Africa and should be considered where a merger or acquisition involves a South African company.

A wide range of provisions may apply to M&A transactions involving South African companies and thus need to be considered, such as:

— Whether the requisite director and/or shareholder approval required for the transaction: For example, if a company is disposing of the greater part of its assets or business, shareholder approval (in the form of a special resolution, in which 75 percent of the shareholders vote in favor of passing the resolution) is required, in addition to the approval of the board of directors of the company disposing of the greater part of its assets or business.

— Any restrictions or formalities that may be prescribed in a company's memorandum of incorporation (MOI).

— Whether the acquisition of the business or of the shares in a South African company requires the approval of the Takeover Regulation Panel (TRP): The TRP and takeover regulations apply to regulated companies, which include public and state-owned companies, and to private companies if their MOI provides for their application or if 10 percent or more of its shares of such private company were transferred within the previous 24 months. The takeover regulations could apply to private companies irrespective of their size, because the test depends not on the number of shareholders or the size of shareholder equity, but rather on the percentage of shares transferred over a period. The Companies Act also includes provisions relating to required disclosure of share transactions, mandatory offers, comparable and partial offers, restrictions on frustrating action and prohibited dealings before and during an offer.

— Whether the proposed transaction contemplates the company providing financial assistance in some manner or form (lending money, guaranteeing a loan or other obligation, securing any debt or obligation or having the purchase price remain outstanding on loan account) to a related or interrelated company: If so, prior approval of the shareholder(s) of the company by way of special resolution and approval of the board of directors is required (in addition to other formalities as set out in section 45 of the Companies Act) before such financial assistance can be advanced.

Other regulatory authorities

Competition considerations — South African merger control

The Competition Act requires that prior approval be obtained from the South African competition authorities for transactions that qualify as notifiable mergers. Where the transacting parties fail to obtain the requisite approval, the Competition Tribunal may impose an administrative penalty of up to 10 percent of the firm's annual turnover in South Africa and exports from South Africa during the preceding financial year.

The Competition Tribunal may also order a party to sell any shares, interest or other assets it has acquired as a result of the merger or declare void any provision of an agreement to which a merger was subject.

In order for a transaction to qualify as a notifiable merger, it must satisfy a 'control test' under the Competition Act and meet the relevant financial thresholds set out in Government Notice 1003 of 2017. These tests are discussed below.

Requirements for notification — acquisition of control

A transaction may require competition approval if the transaction involves the acquisition or establishment of control by one party ('acquiring firm') over the whole or part of the business of another party ('target firm'), subject to the relevant threshold tests also being met.

The acquisition or establishment of control over a business (i.e. a 'merger' in terms of the Competition Act) may be effected in a number of ways, including through the purchase or lease of the assets, shares or interests of the target firm, or through an amalgamation or other combination with the target firm.

The question of whether 'control' has been acquired is often complex and must be answered with reference not only to section 12 of the Competition Act (which sets out instances where control is deemed to be acquired) but also to decisions of the Tribunal and the Competition Appeal Court.

Requirements for notification — threshold test

Not all mergers require prior approval of the competition authorities. Both the control test, discussed above, and a financial threshold test must be met before the merger is

considered as notifiable to the Commission. In terms of the Competition Act read with Government Notice 1003 of 2017, a merger is notifiable to the Commission where:

— the gross annual turnover in, into or from South Africa or the gross asset value in South Africa (whichever value is the greater) of the target company or target business (which includes entities controlled by the target company) is equal to or exceeds ZAR100 million, and

— the combined gross annual turnover in, into or from South Africa or the gross asset value in South Africa (whichever is greater) of the acquiring company (which includes the entire 'control' group of the acquiring company) and the target company or target business (which includes entities controlled by the target company) is equal to or exceeds ZAR600 million.

A merger that meets these thresholds but does not exceed the higher thresholds (see below) is considered to be an 'intermediate merger' and is required to be formally notified to the Competition Commission.

If the merger exceeds the following two upper thresholds, the transaction is considered to be a 'large merger':

— the gross annual turnover in, into or from South Africa or the gross asset value in South Africa (whichever value is the greater) of the target company or target business (which includes entities controlled by the target company) is equal to or exceeds ZAR190 million, and

— the combined gross annual turnover in, into or from South Africa or the gross asset value in South Africa (whichever value is the greater) of the acquiring company (which includes the entire 'control' group of the acquiring company) and the target company or target business (which includes entities controlled by the target company) is equal to or exceeds ZAR6.6 billion.

For purposes of determining the 'gross asset value', only assets in South Africa or arising from activities in South Africa must be taken into account. The turnover and gross asset values as per the previous year's audited financial statements must be used.

Internal group restructures

Intragroup restructures are not exempt from the merger notification requirements set out in the Competition Act. In the Competition Appeal Court decision in *Distillers Corporation (SA) Ltd/SFW Group Ltd and Bulmer (SA) (Pty) Ltd/Seagram Africa (Pty) Ltd* (08/CAC/May01), the court confirmed that every acquisition of direct control (even in a group context) is notifiable if the relevant financial thresholds are met.

Notwithstanding this judgment, the Competition Commission's longstanding approach is to not require notification of intragroup transactions, as long as the group companies involved all form part of one 'single economic entity' for competition law purposes. However, neither the Competition Act nor the case law supports this approach, so parties who implement an intragroup transaction that satisfies both the control and the financial threshold tests without the competition authorities' approval risk being fined under the Competition Act.

In the past, parties to internal group restructurings have applied to the Commission for a non-binding advisory opinion to clarify whether the specific intragroup transaction requires pre-approval from the competition authorities. However, on 23 January 2018, the Commission suspended its advisory opinion service pending the outcome of a Constitutional Court case involving an advisory opinion issued by the Commission to Hosken Consolidated Investments Limited. At the date of writing, the Constitutional Court case had not been heard.

Small mergers

A 'merger' that does not meet the aforementioned financial thresholds is deemed to be a 'small merger'. A party to a small merger is not required to notify the Competition Commission of the merger and may implement it without the commission's approval. However, within 6 months after a small merger is implemented, the commission may require the parties to the merger to notify the commission if, in its opinion, the merger may substantially prevent or lessen competition or cannot be justified on public interest grounds.

The Small Merger Guideline provides that the parties to a small merger are advised to voluntarily inform the Commission by letter of their intention to enter into the transaction, if at the time of entering into the transaction any of the firms, or firms within their groups, are:

— subject to an investigation by the Competition Commission in terms of Chapter 2 (which deals with horizontal and vertical prohibited practices) of the Competition Act, or

— respondents to pending proceedings referred by the commission to the Tribunal in terms of Chapter 2 of the Competition Act.

After receipt of the notification letter, the commission will respond to the parties in writing and inform them whether a formal merger filing is required.

JSE listing requirements

The Johannesburg Stock Exchange (JSE) listing requirements apply to all companies listed on the JSE and to applicants for listings. The requirements aim to raise the levels of certain market practices to international standards and account for situations unique to the South African economy and culture.

Integral functions of the JSE include providing facilities for the listing of the securities of companies (domestic or foreign), providing users with an orderly marketplace for trading in such securities, and regulating accordingly.

The listing requirements reflect, among other things, the rules and procedures governing new applications, proposed marketing of securities and the continuing obligations of issuers. The requirements are intended to ensure that the business of the JSE is carried on with due regard to the public interest.

With respect to M&As, the JSE listing requirements regulate transactions of listed companies by rules and regulations to ensure full, equal and timely public disclosure to all holders of securities and to afford them adequate opportunity to consider in advance, and vote on, substantial changes in the company's business operations and matters affecting shareholders' rights.

The JSE listing requirements are numerous and may be onerous. To comply, a listed company considering a transaction with another party should assess the proposed transaction on the basis of its size, relative to that of the listed company, to determine the full extent of these requirements and the degree of compliance and disclosure needed.

Exchange controls

No cross-border merger or acquisition should be contemplated without considering the likely impact of the strictly enforced South African Exchange Control Regulations.

The exchange control authorities allow investments abroad by South African companies, although a case would have to be made proving, among other things, the benefits to the South African balance of payments, the strategic importance of the proposed investment, and the potential for increased employment and export opportunities. A minimum 10 percent shareholding is generally required. Under a new dispensation, JSE-listed entities may establish one subsidiary to hold African and offshore operations that will not be subject to any exchange control restrictions (various conditions must be met, including that the subsidiary be a South African tax resident).

Remittance of income

Income derived from investments in South Africa is generally transferable to foreign investors, subject to the following restrictions:

— Interest is freely remittable abroad, provided the authorities have approved the loan facility and the interest rate is related to the currency of the loan, such as the Great British Pound Sterling at the London Interbank offered rate (LIBOR).

— Payment of management fees by a South African company to a non-South African exchange control resident company or beneficiary is subject to exchange control approval. The amount paid must be reasonable in relation to the services provided. Payments of such fees by wholly owned subsidiaries of overseas companies are not readily approved. Authorized dealers may approve, against the production of documentary evidence confirming the amount involved, applications by South African residents to effect payments for services rendered by non-residents, provided that the fees payable are not calculated on the basis of a percentage of turnover, income, sales or purchases.

— Agreements for the payment of royalties and similar payments for the use of technical knowhow, patents and copyrights require the prior approval of the exchange control authorities.

— All license agreements relating to the use of technology in manufacture are first vetted by the Department of Trade and Industry. Other license agreements are submitted directly to the exchange control authorities.

— Distributions to shareholders, whether from capital or revenue profits, are freely remittable abroad, provided that the formalities for such distribution as set out in the Companies Act and the South African company's MOI are complied with and the share certificate to which the distributions relate have been endorsed 'non-resident'. The directors of a company may not effect a distribution to shareholders without being satisfied that, at the time of the distribution, the company is solvent and liquid. The non-resident endorsement can be achieved by submitting to an authorized dealer proof that the funds have flowed to South Africa from abroad were used for the original purchase of the shares at market value.

Structuring the transaction

Acquisitions

Acquisitions are generally structured either as a purchase of a business (i.e. the acquisition of assets, assumed liabilities and employees) or the purchase of all or the majority of the shares in a company. The continued existence of the acquired company is not affected by the introduction of the new majority shareholder.

Mergers and amalgamations

The Companies Act, which came into effect on 1 May 2011, introduced a statutory mechanism to give effect to 'mergers or amalgamations'. These provisions do not regulate all mergers or amalgamations in the generic sense; they only

regulate those contemplated in section 113 read together with 116 of the Companies Act.

A merger or amalgamation (as contemplated in section 113 read together with 116 of the Companies Act) is a transaction in which the assets of two or more companies become vested in or come under the control of one company, the shareholders of which then consist of the shareholders (or most of the shareholders) of the merged companies. The single company that owns or controls the combined assets of the merged companies may be either:

— one of the merged companies whose share capital was reorganized to enable it to be the vehicle of the merger

— a new company formed for the purpose of the merger.

Parties are not obligated to apply these provisions. Mergers can be effected using the traditional sale of business or shares mechanisms, as the requirements to give effect to the statutory mechanism are administratively burdensome. For example, the statutory mechanism requires that every creditor of the merging businesses be given notice of the merger and that within a prescribed period after delivery of such notice, a creditor may seek leave to apply to a court for a review of the amalgamation or merger on the grounds (only) that the creditor will be materially prejudiced by the amalgamation or merger. This mechanism is beneficial to use if there is litigation in one of the companies being merged/amalgamated because, while litigation cannot be moved from one company to another without the consent of the other litigation party, this is not the case where the merger and amalgamation provisions (as contemplated in section 113 of the Companies Act, as read with section116) are applied. The litigation proceeding or pending by or against an amalgamating or merging company continues to be prosecuted by or against any amalgamated or merged company.

Note, however, that the definition of 'amalgamation or merger' in the Companies Act is not aligned with the concepts of amalgamation and merger as contemplated in the Income Tax Act.

Acquisitions

An acquisition or takeover is a transaction in which control over a company's assets is obtained by the acquisition of sufficient shares in the company to control it. The continued existence of the acquired company is not affected by the introduction of the new majority shareholder.

Structuring and South African tax relief

The Income Tax Act contains special rules relating to asset-for-share transactions, amalgamation transactions, intragroup transactions, unbundling transactions and liquidation distributions. The purpose of these provisions is to facilitate mergers, acquisitions and restructurings in a tax neutral manner. The rules are very specific and generally do not apply cross-border or when one of the entities in the transaction is a trust or natural person.

— Profitable operations can be absorbed by loss companies in the buyer's group, thereby effectively gaining the ability to use the losses (subject to general anti-tax avoidance rules).

— Interest incurred to finance an asset purchase may be deductible, subject to the interest limitation provisions and transfer pricing rules.

— Assets may be encumbered to assist in financing the acquisition.

Comparison of asset and share purchases

Advantages of asset purchases

— The purchase price (or a portion) can be depreciated or amortized for tax purposes.

— No previous liabilities of the company are inherited.

— It is possible to acquire only part of a business.

Disadvantages of asset purchases

— Possible need to renegotiate supply, technology and other key agreements.

— Need to change stationery and other company documentation.

— A higher capital outlay is usually involved (unless debts of business are also assumed).

— May be unattractive to the seller, thereby increasing the price.

— Accounting profits are affected if acquisition goodwill is written-off.

— The benefit of any tax losses incurred by the target company remains with the seller.

— The tax disallowance of trade receivables purchased without recourse when proven uncollectible.

— Registration of registerable assets and consents required for transfer of agreements and licenses.

— When the buyer will not use the assets to make taxable supplies, VAT or transfer duty become an additional cost.

— If debts are also assumed, no tax deduction or VAT claim can be made on irrecoverable debts.

— Interest on debt funding may not be deductible.

Advantages of share purchases

— Lower capital outlay (purchase net assets only).

— Likely to be more attractive to seller, so price is likely to be lower.

— May benefit from tax losses of the target company (subject to general anti-tax avoidance rules).

— Existing contracts normally are unaffected, so the buyer may gain the benefit of existing supply or technology contracts.

— In certain cases, interest incurred on debt to acquire equity may be deductible where certain provisions of the Income Tax Act are met, as discussed above.

Disadvantages of share purchases

— Assumption of all liabilities that are in the target company, including tax liabilities.

— STT applicable on the higher of the market value or consideration paid for the shares is payable by buyer.

— Depending on the transaction, no tax deduction of the funding cost may be permitted.

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China

Introduction

Over the past year, new People's Republic of China[1] tax rules affecting merger and acquisition (M&A) activities in China were issued by the State Administration of Taxation (SAT) and other government departments. While these new tax rules mostly enhance and update existing rules, they have brought significant changes for investors undertaking M&A activities in China.

China also remains at the forefront of implementing the Organisation for Economic Co-operation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) projects and has issued the Chinese language version of the BEPS deliverables. In February 2018, the SAT updated its rules for determining beneficial ownership (BO) status in order to claim treaty benefits. In September 2015, the SAT issued a public discussion draft on special tax adjustments regarding general anti-avoidance rules (GAAR) and transfer pricing; to date, these rules are not finalized.

The SAT also issued Announcement [2016] No.42 (Announcement 42), which set out guidelines for reporting related-party transactions and contemporaneous documentation. Further, the SAT issued Announcement [2017] No.6 (Announcement 6), which provides for tax risk management, tax investigations and adjustments, and negotiation procedures on special tax adjustments imputed by the Chinese tax authorities.

This report highlights recent M&A-related tax developments in China and then addresses the three fundamental decisions that a prospective buyer typically faces when undertaking M&A transactions in China:

— What should be acquired: the target's shares or its assets?

— What will be the acquisition vehicle?

— How should the acquisition vehicle be financed?

Recent developments

Determining beneficial owner status for claiming treaty benefits

On 6 February 2018, the SAT issued the SAT Announcement [2018] No.9 (Announcement 9), which will replace Guoshuifa [2009] No.601 (Circular 601) and SAT Announcement [2012] No.30 (Announcement 30) as of 1 April 2018, both of which were key circulars setting out the rules for foreign investors claiming treaty benefits on their Chinese-sourced dividend, interest and royalty income ('Chinese-sourced passive income').

In the context of M&A, the key changes to the BO assessment requirements in Announcement 9 are set out below.

Extended the BO safe harbor rules (Announcement 30)

Announcement 30 introduced a BO safe harbor rule that allowed a foreign recipient that is a listed company or directly or indirectly held by a listed company to qualify as a BO for the purpose of claiming treaty benefits on their Chinese-sourced passive income. However, Announcement 30 requires the recipient of the Chinese-sourced passive income to have a 100 percent equity relationship with the listed company, which must be a tax-resident enterprise (TRE) in the same jurisdiction as the recipient.

Announcement 9 extends the BO safe harbor rules to broadly include government bodies and individuals who are either the direct recipients of the Chinese-sourced passive income, or indirect recipients where the intermediary companies (if any) are TREs in the same jurisdiction as the government bodies and individuals.

[1] For the purposes of this report, the terms 'China' and the 'People's Republic of China' are used interchangeably and do not include the Hong Kong and Macau Special Administrative Zones, which have their own taxation systems.

Same jurisdiction rule for treaty benefits

Announcement 9 further allows the immediate recipient that meets the following two conditions to qualify as a BO for the purpose of claiming treaty benefits on their Chinese-sourced passive income:

— the investor who directly or indirectly holds 100 percent of the equity interest in the immediate recipient of Chinese-sourced passive income is a qualified BO

— the investor is a tax resident of either the same jurisdiction as the immediate recipient of Chinese-sourced passive income or another jurisdiction having a tax treaty with China that provides the same or more favorable treatment.

Negative factors under Circular 601

Announcement 9 amended and removed some of the 'seven negative factors' under Circular 601.

The first negative factor considers whether the foreign recipient (as the BO applicant) is obligated to pay or distribute some (e.g. 60 percent or more) or all of its income to its shareholder(s) or other parties within a certain timeframe. This factor has been amended to consider whether the same BO applicant is obligated to pay or distribute 50 percent of its income to its shareholder(s) or other parties or more within 12 months after receiving the Chinese-sourced passive income. Announcement 9 defines 'obligated' to include both agreed obligations and situations where there are no agreed obligations but the income has actually been paid by the BO applicant to its shareholder(s) or other parties.

For the second negative factor considers whether the BO applicant has little or no other business activities except for the properties or rights from which the Chinese-sourced passive income is derived. This factor has been amended to consider the substance of the BO applicant's business activities (including manufacturing, retail and management activities) as well as the function and risk assumed by the BO applicant in carrying out these activities. Additionally, for the investment holding and management activities undertaken by the BO applicant, Announcement 9 clarifies that the substance requirements for carrying on such activities should generally include preliminary study, assessment and analysis, investment decisions, implementation and post-investment management activities. Where the BO applicant's investment holding, management and other business activities are considered insignificant, the BO applicant would be regarded as not carrying on substantial business activities.

A BO applicant that exhibits a number of the negative factors under Announcement 9 would be at risk of losing treaty benefits on its Chinese-sourced passive income.

The issuance of Announcement 9 has further demonstrated the SAT's commitment to implement the BEPS Action Plan recommendations to further improve the overall Chinese tax system. For M&A transactions, the safe harbor rules under Announcement 9 allow for a more efficient and effective structure where the commercial substance of other group companies can now be shared under the same jurisdiction/same treaty benefit rule (provided the relevant conditions are met).

New guidance on withholding tax (WHT) administration

On 17 October 2017, the SAT issued the SAT Announcement [2017] No.37 (Announcement 37) and new official interpretative guidance on withholding tax (WHT) administration. Announcement 37 is effective from 1 December 2017, but certain provisions may apply to unsettled cases occurring before the effective date. Announcement 37 replaces a number of tax circulars, including Circular [2009] No.3 (Circular 3) on WHT administration, the remaining provisions in Circular [2009] No.698 (Circular 698) on the calculation of capital gain, and certain other tax circulars.

In a M&A context, the key changes to the existing WHT administration rules introduced under Announcement 37 broadly as follows:

— *Tax on gains arising from transfer of Chinese equity investments*

  Announcement 37 provides guidance on calculating the gain arising from transfer of Chinese equity investments by foreign investors, clarifying how the tax basis should be apportioned where the foreign investors have made several investments in the same Chinese resident enterprise at different points in time. The cost of the equity investment ('net value') has been clarified to include adjustments for any asset value write-down/increment that was previously recognized for Chinese tax purposes.

  The announcement also provides guidance on what foreign exchange rates should be adopted when calculating the gain arising from transfer of the Chinese equity investments by the foreign investors in cases where the cost base and/or consideration of the Chinese equity investments are denominated in a foreign currency.

— *WHT payment obligations of withholding agents and foreign payees*

  For dividends distributed by a Chinese resident enterprise to its foreign shareholder(s), withholding agents are now required to make the WHT payment on the date when the dividends are actually paid out of China (as opposed to the earlier of the date on which the dividend declaration is made or the actual payment date).

  Where consideration for Chinese assets is to be paid in installments, the investment costs are now treated as being recovered first, followed by the crystallization of the disposal gain. The timing of WHT obligation is deferred as a result.

These changes provide a more reasonable timeframe for WHT payments by foreign payees/investors, as they are not obligated to pay the WHT until they are instructed to do so by the Chinese tax authorities.

— *Responsibilities of withholding agents*

Announcement 37 clarifies the following situations when a withholding agent fails to withhold tax on behalf of the foreign payee/investor:

— If the tax is regarded as having been withheld by the withholding agent but not remitted to the in-charge tax authorities, then the in-charge tax authorities may pursue the withholding agent for the unremitted tax.

— If the tax was not withheld by the withholding agent at all, then the in-charge tax authorities may pursue either the withholding agent or the foreign payee/investor for the unpaid tax.

While Announcement 37 reduces the WHT compliance burdens of the withholding agents and non-Chinese resident payees/investors, it has raised a number of ambiguities that need to be addressed. For example, it remains uncertain whether penalty interest should be imposed on a seller under an indirect transfer transaction, if taxable under SAT Announcement [2015] No.7 (Announcement 7). Therefore, it is important to consider the new WHT administration timing requirements when undertaking M&A transactions in China, in particular, in sale and purchase agreement (SPA) negotiations involving the indirect transfer of Chinese taxable assets.

Deferral of WHT on dividends reinvested into 'encouraged projects'

On 28 December 2017, the Ministry of Finance (MOF), Ministry of Commerce (MOFCOM), National Development and Reform Commission (NDRC) and SAT jointly issued Caishui [2017] No.88 (Circular 88). The SAT subsequently issued the SAT Announcement [2018] No.3 on 2 January 2018. Collectively, these circulars set out the rules and guidance providing foreign investors with preferential WHT deferral treatment on dividend reinvestments in China.

The above rules and guidance broadly cover the following:

Conditions for attaining the dividend WHT deferral

Circular 88 outlines the following four principal conditions that foreign investors must all satisfy to attain the WHT deferral benefit:

1. **Direct reinvestment**

   The distributable profits of the Chinese resident enterprise must be directly reinvested in the form of a capital increase, capital injection or acquisition of equity in another Chinese resident enterprise.

   The scope of direct reinvestment excludes the acquisition of equity in publicly listed companies in China (except for Chinese companies that have met the requirements of 'strategic investment' defined under the relevant MOFCOM Order) and equity in related Chinese resident enterprises.

2. **Eligible profits for distribution**

   Profits distributed by the Chinese resident enterprise to its foreign investors must be in the form of a profit distribution and other returns on equity investments that arise from the distribution of realized retained earnings of the Chinese resident enterprise, including its undistributed earnings from prior years.

3. **Direct payment/transfer of cash dividends and non-cash assets**

   Regardless of whether the dividends being distributed by the Chinese resident enterprise is in the form of cash or non-cash assets (e.g. tangible goods), the distribution must be transferred to the designated accounts of the invested Chinese resident enterprise or the equity transferor, not via a third party.

4. **'Encouraged projects'**

   The 'encouraged projects' (i.e. the invested Chinese resident enterprises) must engage in business activities that fall within the prescribed scope of the encouraged foreign investment industry catalogue, including manufacturing, provision of certain services, research and development (R&D) activities and investment in construction projects or procurement of machinery equipment.

— *Filing procedures and follow-up administration for deferring dividend WHT*

The withholding agent (i.e., the Chinese resident enterprise distributing the dividends to its foreign investors) should prepare records required for claiming the dividend WHT deferral from the in-charge tax authorities, which are expected to perform follow-up administrative duties. Any non-compliance identified could be followed up with the withholding agent or directly with the foreign investors.

— *Divestment of investments in Chinese resident enterprises and other cases*

The following rules apply where foreign investors have divested their reinvestments in the Chinese resident enterprise on which the dividend WHT deferral under Circular 88 has been obtained:

— Where the divestment is completed through an equity transfer, buy-back and liquidation arrangement (among others), the non-Chinese resident investors are required to report and pay the relevant dividend WHT to the in-charge tax authorities within 7 days after receiving the relevant payments for the divestment.

- Where the divestment is completed by way of an internal restructuring that qualifies for the special tax treatment (STT) under Caishui [2009] No.59 (Circular 59) (discussed later), the dividend WHT deferral can be sustained.

- *Effective date and retrospective effect*

  Circular 88 applies retrospectively from 1 January 2017. Any non-Chinese resident investors who have met the requirements under Circular 88 to attain the dividend WHT deferral can retrospectively apply for the deferral benefit and a refund of the dividend WHT previously paid on or after 1 January 2017. The application must be made within 3 years from the date that the dividend WHT was actually paid to the in-charge tax authorities.

As with many tax circulars in China, Circular 88 provides new guidance on the WHT treatment on reinvestment projects but also raises uncertainties (e.g. whether the dividend WHT rates under tax treaty can claimed by the foreign investors if they divest their equity interest in the reinvested Chinese resident enterprises). KPMG in China expects the SAT to address these uncertainties through supplementary guidance in the future. When planning for future reinvestment of dividends in China for M&A transactions, it would be important to consider whether such reinvestment would fall within the scope of Circular 88, and especially whether the conditions for accessing the dividend WHT deferral benefits would be met.

Offshore indirect disposals

China's existing offshore indirect disposal reporting and taxation rules were completely revamped, with Announcement 7 (replacing Circular 698, which was abolished by Announcement 37).

The offshore indirect disposal rules seek to ensure that Chinese tax cannot be avoided through the interposition of an offshore intermediary holding entity that holds the Chinese assets. Under these rules, if an offshore indirect disposal of Chinese taxable property (discussed further below) by a non-Chinese TRE is regarded as being undertaken without reasonable business purposes with the aim to avoid Chinese corporate income taxes (CIT), the transaction would be re-characterized as a direct transfer of Chinese taxable property and subject to Chinese WHT at the rate of 10 percent under the Chinese GAAR.

However, the tax basis for calculating taxable gains for indirect transfers has been unclear, and the practice varies between different locations and tax authorities.

Compared with Circular 698, Announcement 7 expands the scope of the transactions covered, enhances the enforcement mechanism and sets out a more specific framework for dealing with so-called 'tax arrangements' with the introduction of a safe harbor and a black list. The major aspects of the rules under Announcement 7 are as follows:

- Announcement 7 not only captures transfers of offshore holding companies that ultimately own equity interests of the Chinese resident companies, but also covers foreign companies holding Chinese immovable properties and assets belonging to Chinese permanent establishments (PE) of foreign companies. The types of offshore transactions that can trigger the rules span from simple offshore equity transfers to transfers of partnership interests/convertible bonds, as well as restructurings and potentially share redemptions.

- While the seller or the buyer are not required to report the offshore transactions to the tax authorities, Announcement 7 requires the buyer to act as the withholding agent and apply 10 percent WHT to the purported transfer gain. The withholding agent faces stringent penalties for failure to pay tax within the required timeframe if the seller also fails to pay its taxes to the Chinese tax authorities. However, the buyer can mitigate potential penalties by making a timely reporting of the transaction. Note that the seller, as the taxpayer, is still on the hook for tax not withheld by the buyer.

- Extensive new guidance was introduced on whether a transaction lacks 'reasonable business purposes' and thus should be subject to tax under the Chinese GAAR. This includes a '7 factors test', which considers:

  - whether the offshore company's principal value or source of income is derived from China

  - the functionality and duration of existence of the offshore holding company and 'substitutability' of the offshore transaction with an onshore direct disposal of the Chinese taxable assets

  - the overseas taxation position of the offshore transfer, including the application of a tax treaty.

A parallel 'automatic deeming' test was introduced, which treats an indirect transfer transaction as lacking reasonable business purpose if, among other black-list factors, more than 75 percent of the value and more than 90 percent of the income or assets of the offshore holding company are derived from or attributable to China. New safe harbor rules to deem a transaction as having 'reasonable business purposes' or otherwise not taxable cover the following situations:

- foreign enterprises buying and selling securities on the public market

- cases where a tax treaty would apply to cover a transaction recharacterized as a direct disposal

- intragroup reorganizations within a corporate group that meet certain conditions.

In practice, Announcement 7 creates many challenges in its application to indirect transfer transactions due to the difficulties of aligning buyer and seller positions on

the reporting and taxability of an indirect transfer M&A transaction. The seller and buyer sometimes find it difficult to agree on whether the Chinese tax authorities would consider an indirect transfer transaction as lacking reasonable business purposes, particularly where there is certain substance offshore. Given the potential stiff penalties that could apply, particularly for buyers as the withholding agents, and given the potential mitigation of penalties through timely voluntary reporting of the indirect transfer cases to the Chinese tax authorities, disputes can arise between transacting parties over whether transactions should be reported at all and whether, and how much, tax needs to be paid or withheld. Historically, escrow and indemnity arrangements have been used in practice. Now, buyers increasingly tend to require sellers to timely report the transaction to the Chinese tax authorities as a condition for closing the deal.

Announcement 7 was supplemented by Shuizonghan [2015] No. 68 (Circular 68), which provides further implementation guidance and an improved reporting mechanism. The circular clarifies Announcement 7's measures regarding formal receipts for taxpayer reporting (giving assurance in relation to the penalty mitigation measures), single reporting for transferred Chinese taxable assets in multiple locations in China, and GAAR procedures (including SAT review and appeal procedures). However, there is still a need for a clarified refund process, confirmation on the applicability of safe harbors, and timeframes for the conclusion of the GAAR investigations.

Also, there have been cases in the past where the gains on the sale of offshore companies were regarded as Chinese-sourced on the basis that the offshore company's tax residency is deemed to be in the Chinese under Chinese domestic tax laws (broadly based on the place of effective management). The approach was first applied in a Circular 698 reporting case in the Heilongjiang province of China in 2012 that was made public. Hence, the tax resident status of foreign incorporated enterprises (particularly those controlled by Chinese residents) should be considered when assessing whether gains from the disposal of Chinese equities offshore by foreign investors in the M&A space could be taxable in the Chinese resident company simply under Chinese domestic tax laws.

This additional exposure needs to be monitored and factored into M&A transactions where foreign investors make offshore indirect acquisitions and disposals of Chinese investments.

Negotiations may be further complicated where investors seek to obtain warranties and indemnities that the deal target is not effectively managed from the Chinese.

Value-added tax and land appreciation tax on onshore indirect disposals of properties situated in China

Under Chinese land appreciation tax (LAT) regulations, a transfer of an equity interest in Chinese TRE technically should not give rise to LAT as any underlying properties are not directly transferred. However, the tax authorities may seek to impose LAT on the transfer of an equity interest in a Chinese company that directly holds real estate if the transfer consideration is equivalent to the value of the real estate and/or the primary purpose of the equity transfer is to transfer the land use right and property (rather than the company). There have been some enforcement cases where transfers of equity interests in Chinese property holding companies were re-characterized as direct transfers of Chinese properties for LAT purposes and thus LAT was imposed on the sale of equity interests in the Chinese holding company as if the underlying property had been disposed of.

Further, a local tax circular issued by the Hunan tax authority (i.e. Xiang Di Shui Cai Xing Bian Han [2015] No.3) clarifies that the 'transfer of properties in the name of transfer of equity' should be subject to LAT, because the transfer of Chinese company shares, which in substance represents a transfer of the underlying Chinese properties, should be subject to LAT.

Currently, only transactions that are deemed as 'disguised' property transfers would be subject to LAT, which would be assessed case-by-case. In making the assessments, the Chinese tax authorities would look at certain criteria to decide whether the nature of the transaction is, in substance, a property transfer transaction. These criteria include:

— whether the share transfer consideration was equal to, or close to the valuation of the Chinese properties

— the duration of the holding period

— the transaction agreements.

The look-through of an equity transfer to impose LAT is not explicitly supported by existing LAT law (which, unlike the CIT Law, does not have an anti-avoidance provision). Hence, these look-through cases are still rare in practice, but investors should closely monitor future developments as this approach could significantly affect investment returns.

The position under China's new value added tax (VAT) rules, in effect since 1 May 2016, is similar. That is, the transfer of unlisted equity interests is not subject to VAT. However, the transfer of real estate assets is generally subject to 11 percent VAT (or a reduced rate of 5 percent, where certain grandfathering arrangements apply). The new VAT rules contain an anti-avoidance provision and the tax authorities could take a look-through approach similar to the above on LAT and impose VAT on disguised transfers of properties via equity transfers.

Treaty relief claims

In 2009, the Chinese tax authorities adopted measures to monitor and resist granting tax treaty relief in cases of perceived treaty shopping through the use of tax treaties to gain tax advantages. Guoshuifa [2009] No. 124 (Circular 124, issued in 2009, which is superseded by another tax circular;

see below) introduced procedural requirements under which tax authority pre-approval may be required before treaty relief can be applied. This has made it easier for the tax authorities to identify cases where the taxpayer is relying on treaty protection.

Circular 601 and Announcement 30 (both of which will be superseded by Announcement 9 from 1 April 2018) and Shuizonghan [2013] No. 165 (Circular 165, issued in April 2013) set out the factors that the Chinese tax authorities should take into account in deciding whether a treaty's BO requirements are satisfied. These circulars also provide guidance on the interpretation of the negative factors.

In 2015, the SAT issued SAT Announcement [2015] No. 60 (Announcement 60), which replaced Circular 124 and revamped the tax treaty relief system. The new system, which took effect as of 1 November 2015, abolishes the tax treaty relief pre-approval system under Circular 124. Instead, the taxpayer self-determines whether tax treaty relief applies and informs the withholding agent (or the tax authority directly where no withholding agent is involved) that it will be claiming the treaty relief.

To encourage the withholding agent to process the relief without taking on excessive risk and uncertainty, the detailed tax treaty relief forms, completed by the taxpayer, include a section requiring information that the withholding agent will check before applying the treaty rate and a separate, more detailed section that the tax authorities may refer to during their follow-up procedures. The withholding agent's section includes, along with basic details on how the taxpayer satisfies the terms of the treaty, a BO test defined under Circular 601 (to be replaced by Announcement 9 from 1 April 2018), which is a control test along the lines of that applied in other countries.

Following the release of Announcement 60, on 29 October 2015, the SAT further issued Shuizongfa [2015] No. 128 (Circular 128) to clarify the follow-up procedures as emphasized in Announcement 60. Circular 128 stipulates that the Chinese tax authorities would audit at least 30 percent of the tax treaty relief claim cases on dividends, interest, royalties and capital gain within 3 months after the end of each quarter and perform special audits to assess the risks of treaty abuse in various aspects. If the tax authorities discover on examination that treaty relief should not have applied and tax was underpaid, the tax authorities would instruct the taxpayer to pay the underpaid tax within a set time period. If the payment is not made on time, then the tax authorities can pursue other Chinese sourced income of the non-resident or take stronger enforcement action under the Chinese Tax Collection and Administration Law. The tax authorities may also launch anti-avoidance proceedings, either under the relevant anti-abuse articles of tax treaties or the domestic GAAR.

In view of Circular 128, there have been cases where the Chinese tax authorities have sought to recover underpaid taxes from treaty relief claimants due to their improper treaty claims. In a recent case in Quanzhou City, Fujian Province published in 2017, a Hong Kong (SAR) company was regarded by the Chinese tax authorities as a conduit company that was established predominantly for the purpose of attaining the reduced WHT rate of 5 percent instead of 10 percent under the Hong Kong-China tax treaty. Consequently, the Chinese tax authorities have recovered the underpaid dividend WHT of 10.46 million Chinese Yuan Renminbi (CNT) and imposed a late payment surcharge of CNY423,600.

On 6 February 2018, the SAT issued Announcement 9, which will replace Circular 601 and Announcement 30 as of 1 April 2018 (see 'Recent developments').

In summary, the treaty relief system under Announcement 60 remains as an open and efficient channel to access treaty relief and aid the conduct of M&A and restructuring transactions. However, taxpayers have a greater burden to ensure that self-assessment is grounded in prudence and satisfies the relevant conditions, including those under Circular 601 and Announcement 30 (before 1 April 2018) and Announcement 9 (on and after 1 April 2018).

While Announcement 9 has set out the relevant rules and addressed certain issues pertaining to treaty benefit claims for foreign investors, there are still uncertainties regarding how the assessment of BO of dividends distributed from Chinese resident enterprises to their foreign shareholders would align with international practice and norms. For example, it is uncertain whether unincorporated entities such as partnerships and trusts that are paying foreign CIT in their own capacities would be eligible to apply for treaty benefits in their own right, rather than being treated by the Chinese tax authorities as a pass-through.

Reorganization relief

In 2014 and 2015, a number of key improvements to the Chinese tax restructuring reliefs were made to the STT that results in tax deferral treatment for corporate restructurings. The changes lower the eligibility threshold and introduced new ways to access STT.

Circular 59, the principal tax regulation on restructuring relief issued in 2009, sets out the circumstances in which companies undergoing restructuring can elect for STT. Absent the application of STT, the general tax treatment (GTT) requires recognition of gains/losses arising from the restructuring. The STT conditions include two tests:

— a 'purpose test' akin to the Chinese GAAR (i.e. the transaction must be conducted for reasonable commercial purposes and not for tax purposes)

— a 'continuing business test' (i.e. there is no change to the original operating activities within a prescribed period after the restructuring).

The conditions also set out two threshold tests that aim to ensure the continuity of ownership and the continued integrity of the business following the restructuring. Under these tests:

— consideration must comprise 85 percent of equity

— 75 percent of the equity or assets of the target must be acquired by the transferee.

Although Circular 59 was intended to provide favorable tax treatment to restructuring transactions, STT had not been widely used due to the high thresholds. Caishui [2014] No. 109 (Circular 109) was subsequently issued to lower the 75 percent asset/equity acquisition threshold to 50 percent. This facilitates the conduct of many more takeovers/restructurings in a tax-neutral manner. Circular 109 also introduces a new condition for STT that removes the 75 percent ownership test. The new condition permits elective non-recognition of income on transfer of assets/equity between two Chinese TREs that are in a '100 percent holding relationship', provided no accounting gains/losses are recognized. Both the purpose test and the continuing business test from Circular 59 hold, and the tax basis of transferred assets for future disposal is their original tax basis. The supplementary SAT Announcement [2015] No. 40 (Announcement 40) clarifies certain terms used in Circular 109 and spells out in detail the situations to which the relief applies.

Given that China does not, unlike many other countries, have comprehensive group relief or tax consolidation rules, the introduction of this intragroup transfer relief is a real break-through in Chinese tax law. However, the relief does not cover transfers of Chinese assets by non-TREs (whether between two non-TREs or between a non-TRE and a TRE). Taxpayers also need to be aware of the emphasis being placed by tax authorities on the purpose test, particularly as the intragroup transfer relief opens the door to tax loss planning strategies that previously were not possible under Chinese tax law.

SAT Announcement [2015] No. 48 (Announcement 48) also abolishes the tax authority pre-approvals previously needed for STT to be applied, moving instead to more detailed STT filing at the time of the annual CIT filing. The transition from tax authority pre-approval to taxpayer self-determination on the applicability of STT (and on tax treaty relief claims as discussed earlier) is in line with the broader shift in Chinese tax administration away from pre-approvals. However, while the abolition of pre-approvals potentially expedites transactions, it also places a greater burden on taxpayer risk management procedures and systems to ensure that treatments adopted are justified and adequately supported with documentation.

VAT reform

China's transition from business tax (BT) to VAT has been a major tax reform initiative, which was designed to facilitate the growth and development of the services sector and to relieve the indirect tax impact in many business-to-business transactions. Since 2012, the VAT reforms have been gradually expanded to sectors which were historically under the BT regime.

As of 1 May 2016, all transactions involving goods and/or services became within the scope of VAT, and BT is no longer in operation. The following sectors are among the last major batch that transitioned from BT to VAT from 1 May 2016: real estate and construction, financial services, and lifestyle services (which is a general category capturing all other services).

In the context of M&A transactions, the VAT reform rules significantly affect how transactions are undertaken, whether by way of asset or business transfer or equity. Given the significant changes in VAT rates for some industries (compared with the previous BT rates), the ability to recover VAT under contracts that may be acquired or assumed as part of any M&A transactions is a significant area of focus. The funding of transactions also needs to take into account the VAT implications, given that China's VAT system applies 6 percent VAT to financial services, including interest income.

The Chinese government issued a number of circulars during 2017 to clarify certain VAT-related uncertainties and adjust certain existing VAT rates. Therefore, it is expected that the Chinese VAT system will continue to evolve in the future, to further update and clarify various practical aspects of the Chinese VAT reform that remain uncertain.

More recently, as of 1 January 2018, new VAT rules were introduced to reduce the applicable VAT rate for the operation of asset management products, such as trusts and funds, to 3 percent (from 6 percent) for Chinese asset managers but without the ability to claim input VAT credits. This change affects interest income derived from such asset management products, as well as gains on trading of financial products (among other things). However, whether the new VAT rate would also apply to foreign investors that qualify as a 'qualified foreign institutional investor' or 'Renminbi qualified foreign institutional investor' is currently unclear, given that such an investor cannot register itself as a VAT taxpayer for Chinese VAT purposes.

Asset purchase or share purchase

In addition to tax considerations, the execution of an acquisition in the form of either an asset purchase or a share purchase in the Chinese is subject to regulatory requirements and other commercial considerations.

Some of the tax considerations relevant to asset and share purchases are discussed below.

Purchase of assets

A purchase of assets usually results in an increase in the cost base of those assets for capital gains tax purposes,

although this increase is likely to be taxable to the seller. Similarly, where depreciable assets are purchased at a value greater than their tax-depreciated value, the value of these assets is refreshed for the purposes of the buyer's tax depreciation claim but may lead to a claw-back of tax depreciation for the seller.

Where assets are purchased, it may also be possible to recognize intangible assets for tax amortization purposes. Asset purchases are likely to give rise to relatively higher transaction tax costs than share purchases, which are generally taxable to the seller company (except for stamp duty, which is borne by both the buyer and seller, and deed tax, which is borne by the buyer of land and real property). Further, for asset purchases, historical tax and other liabilities generally remain with the seller company and are not transferred with the assets. As clarified in 'Choice of acquisition funding', it may be more straightforward, from a regulatory perspective, for a foreign invested enterprise to obtain bank financing for an asset acquisition than for a share acquisition.

The seller may have a different base cost for their shares in the company as compared to the base cost of the company's assets and undertaking. This, as well as a potential second charge to tax where the assets are sold and the company is liquidated or distributes the sales proceeds, may determine whether the seller prefers a share or asset sale.

Caishui [2014] No. 116 (Circular 116) allows for deferral of tax on gains deemed to arise on a contribution of assets by a TRE into another TRE in return for equity in the latter. The taxable gain can be recognized over a period of up to 5 years, allowing for the payment of tax in installments. This relief, potentially also extending to the contribution of assets by minority investors into a TRE, complements the intra-100 percent group transfer relief under Circulars 59 and 109 (see 'Recent developments').

According to SAT Announcement [2015] No. 33 (Announcement 33), where applicable, taxpayers can elect to apply either the relief under Circular 116 or the intra-100 percent group transfer relief under Circulars 59 and 109.

Further, SAT Announcement [2011] No. 13 (Announcement 13), issued in February 2011, provided a VAT exclusion for the transfer of all or part of a business pursuant to a restructuring. However, certain limitations in the practical applicability of the relief still exist.

Purchase price

For tax purposes, it is necessary to apportion the total consideration among the assets acquired. It is generally advisable for the purchase agreement to specify the allocation, which is normally acceptable for tax purposes provided it is commercially justifiable. It is generally preferable to allocate the consideration, to the extent it can be commercially justified, against tax-depreciable assets (including intangibles) and minimize the amount attributed to non-depreciable goodwill. This may also be advisable given that, at least under old Chinese generally accepted accounting principles (GAAP), goodwill must be amortized for accounting purposes, limiting the profits available for distribution.

Goodwill

Under CIT law, expenditure incurred in acquiring goodwill cannot be deducted until the complete disposal or liquidation of the enterprise.

Amortization is allowed under the CIT law for other intangible assets held by the taxpayer for the production of goods, provision of services, leasing or operations and management, including patents, trademarks, copyrights, land-use rights, and proprietary technologies, etc. Intangible assets can be amortized over no less than 10 years using the straight-line method.

Depreciation

Depreciation on fixed assets is generally computed on a straight-line basis. Fixed assets refer to non-monetary assets held for more than 12 months for the production of goods, provision of services, leasing or operations and management, including buildings, structures, machinery, mechanical apparatus, means of transportation and other equipment, appliances and tools related to production and business operations.

The residual value of certain fixed assets (i.e. the part of the asset value that is not tax-depreciable) is to be reasonably determined based on the nature and use of the assets. Once determined, the residual value cannot be changed. The minimum depreciation periods for relevant asset types are as follows:

Assets	Years of depreciation
Buildings and structures	20
Aircraft, trains, vessels, machinery and other production equipment	10
Instruments, tools, furniture, etc., related to production and business operations	5
Transportation vehicles other than aircraft, locomotives and ships	4
Electronic equipment	3

Source: KPMG China, 2018

Any excessive accounting depreciation over the tax depreciation calculated based on the above minimum depreciation period should be added back to taxable income for CIT purposes.

Certain fixed assets are not tax-depreciable, including:

— fixed assets, other than buildings and structures, that are not in use

— fixed assets leased from other parties under operating or finance leases

— fixed assets that are fully depreciated but still in use

— fixed assets that are not related to business operations

— separately appraised pieces of land that are booked as fixed assets

— other non-depreciable fixed assets.

Tax attributes

Generally, tax attributes (including tax losses and tax holidays) are not transferred on an asset acquisition. They generally remain with the enterprise until extinguished.

Value added tax

As of 1 May 2016, VAT has fully replaced BT, such that any transactions involving the sale of goods or provision of services is potentially within the scope of VAT. VAT is levied at the rates of 3 percent, 6 percent, 11 percent and 17 percent, depending on the good or service. Generally, the sale or importation of goods, or the lease of goods is subject to 17 percent VAT. Transportation, certain telecommunication services as well as sales and lease of real estate are subject to 11 percent VAT. Most other services are subject to 6 percent VAT.

Certain business reorganizations, including certain transfers of a business where all assets are disposed of, employees transferred and liabilities assumed, are currently outside the scope of VAT, provided certain conditions are met.

However, the scope of the concession is more limited in China compared with equivalent concessions for the sale of a going concern in other countries. A sale of assets, in itself, may not be regarded as a transfer of a business and should not benefit from the concession. Announcement 13, issued in February 2011, clarified that a VAT exclusion may be available for the transfer of part of a business, though in practice it can be difficult to access. Given that in China there is generally no ability for a buyer to obtain a refund of excess VAT credits (instead, excess credits may be carried forward, potentially for an indefinite period), the cash flow implications can be significant and long-lasting.

Transfer taxes

Stamp duty is levied on instruments transferring ownership of assets in China. Depending on the type of assets, the transferor and the transferee are each responsible for paying stamp duty of 0.03 to 0.05 percent of transfer consideration for the assets in relation to their own copies of the transfer agreement (i.e. a total of 0.06 percent to 0.10 percent stamp duty payable). Where the assets transferred include immovable property, deed tax, land appreciation tax and VAT and local surcharges may also need to be considered.

Purchase of shares

The purchase of a target company's shares does not result in an increase in the base cost of that company's underlying assets; there is no deduction for the difference between underlying net asset values and consideration. There is no capital gains participation exemption under Chinese tax law, therefore a Chinese seller is subject to CIT or WHT on the sale of shares; however, tax deferral relief may be available if the consideration consists of shares in the buyer and the various conditions for attaining the reorganization relief (discussed earlier) can be satisfied.

Tax indemnities and warranties

In a share acquisition, the buyer assumes ownership of the target company together with all of its related liabilities, including contingent liabilities. Therefore, the buyer normally needs more extensive indemnities and warranties than in the case of an asset acquisition. An alternative approach is for the seller's business to be moved into a newly formed subsidiary so the buyer can acquire a clean company. However, for tax purposes, unless tax relief applies, this may crystallize any gains inherent in the underlying assets and may also crystallize a tax charge in the subsidiary to which the assets were transferred when acquired by the buyer.

As noted earlier (see 'Recent developments), a pressing new issue that must be dealt with through warranties and indemnities concerns the impact on buyers of shares in offshore holding companies where the seller has not complied with the Announcement 7 (previously Circular 698) reporting and filing requirements. Purchasers are subject to WHT obligations in the case of an Announcement 7 enforcement and could be subject to potential penalty where the seller fails to report the transaction and pay the taxes. The buyer may ask the seller to warrant and provide evidence that they have made the reporting or indemnify them for tax and/or penalty ultimately arising.

To identify such tax issues, it is customary for the buyer to initiate a due diligence exercise, which normally incorporates a review of the target's tax affairs.

Tax losses

Under the CIT law, generally, a share transfer resulting in a change of the legal ownership of a Chinese target company does not affect the Chinese tax status of the Chinese target company, including tax losses. However, in light of the introduction of the GAAR, the buyer and seller should ensure that there is a reasonable commercial rationale for the underlying transaction and that the use of the tax losses of the target is not considered to be the primary purpose of the transaction, thus triggering the GAAR's application.

Provided that the GAAR does not apply, any tax losses of a Chinese target company can continue to be carried forward

to be offset against its future profits for up to 5 years from the year in which the loss was incurred after the transaction. China currently has no group consolidation regulations for grouping of tax losses.

There is a limitation on the use of tax losses through mergers.

Crystallization of tax charges

China has not yet imposed tax rules to deem a disposal of the underlying assets under a normal share transfer, but the buyer should pay attention to the inherent tax liabilities of the target company on acquisition and the potential application of GAAR. As Chinese tax law does not provide for loss- or VAT-grouping, there is no 'degrouping' charge to tax (although care must be taken on changes of ownership where assets/shareholdings have recently been transferred within the group and reorganization relief has been claimed).

The tax authorities may seek to impose VAT/LAT on a 'disguised' property transfer under the cover of an equity transfer. As discussed, however, the imposition of LAT and VAT based on the look-through of the equity transfer is not explicitly supported by existing LAT or VAT laws.

Pre-sale dividend

In certain circumstances, the seller may prefer to realize part of the value of the target company as income by means of a pre-sale dividend. The rationale is that the dividend may be subject to a lower effective rate of dividend WHT than capital gains, where treaty relief is available. Hence, any dividends paid out of retained earnings prior to a share sale would reduce the proceeds of sale and the corresponding gain arising on the sale, leading to an overall lower WHT leakage. The position is not straightforward, however, and each case must be examined based on its facts.

Transfer taxes

The transferor and transferee are each responsible for the payment of stamp duty of 0.05 percent of the transfer consideration for the shares in a Chinese company in relation to their own copies of the transfer agreement (i.e. a total of 0.10 percent stamp duty payable).

Tax filing requirements for STT on special corporate reorganizations

The STT on special corporate reorganizations is elective. To enjoy the tax deferral under a corporate reorganization, applicants must submit, along with their annual CIT filings, relevant documentation to substantiate their reorganizations' qualifications for the STT. Failure to do so results in the denial of the tax-deferred treatment.

Tax clearance

Currently, the Chinese tax authorities do not have any system in place for providing sellers of shares in an offshore holding company, where the sellers have made their Announcement 7 (previously Circular 698) reporting, with a written clearance to the effect that the arrangement will not be attacked under the GAAR. Consequently, as noted above, buyers should seek to protect themselves through appropriate warranties and indemnities in the SPA.

Choice of acquisition vehicle

The main forms of business enterprise available to foreign investors in China are discussed below.

Foreign parent company

The foreign buyer may choose to make the acquisition itself, perhaps to shelter its own taxable profits with the financing costs. However, China charges WHT at 10 percent on dividends, interest, royalties and capital gains arising to non-resident enterprises. So, if relevant, the buyer may prefer an intermediate company resident in a more favorable treaty territory (WHT can be reduced under a treaty to as low as 5 percent on dividends, 7 percent on interest, 6 percent on royalties and 0 percent on capital gains). Alternatively, other structures or loan instruments that reduce or eliminate WHT may be considered.

Non-resident intermediate holding company

If the foreign country taxes capital gains and dividends received from overseas, an intermediate holding company resident in another territory could be used to defer this tax and perhaps take advantage of a more favorable tax treaty with China. As outlined in 'Recent developments', the buyer should be aware of the rigorous enforcement of the anti-treaty shopping provisions by the Chinese tax authorities — especially against the backdrop of the OECD BEPS Action Plan, which may restrict the buyer's ability to structure a deal in a way designed solely to obtain such tax benefits.

Further, in setting out the Chinese interpretation of BO for tax treaty relief, Circular 601 (which is replaced by Announcement 9 as of 1 April 2018) effectively combines a BO test (which in most countries is a test of 'control' over income and the assets from which it derives) with an economic substance-focused treaty-shopping test. Application of the treaty-shopping test as an element of the BO test, rather than as an application of the Chinese GAAR, prevented taxpayers from arguing their 'reasonable business purposes' in using an overseas holding, financing or intangible property leasing company, as the GAAR procedures would allow them to do so. The public discussion draft on 'special tax adjustments' (not yet finalized at the time of writing) reiterates that the Chinese tax authorities are empowered to initiate general anti-avoidance investigations and apply the GAAR on treaty shopping. Hence, the development of the BEPS implementation in China and the potential issuance of the draft 'special tax adjustments' rules should continue to be observed under the new tax treaty relief system.

Announcement 7 should also be kept in mind where an offshore indirect disposal is contemplated. However, even in the absence of treaty relief, the 10 percent WHT compares favorably with the 25 percent tax that would be imposed if the acquisition were held through a locally incorporated vehicle.

Further, as explained in 'Debt' later in this report, debt pushdown at the Chinese level may be difficult and the Chinese corporate law requirement to build up a capital reserve that may not be distributed until liquidation might also favor the use of a foreign acquisition vehicle (however, see 'Chinese partnership' below). Where the group acquired has underlying foreign subsidiaries, the complexities and vagaries of the (little-used) Chinese foreign tax crediting provisions must also be taken into account.

Wholly foreign-owned enterprise

— A wholly foreign-owned enterprise may be set up as a limited liability company by one or more foreign enterprises or individuals.

— Profits and losses must be distributed according to the ratio of each shareholder's capital contribution. Earnings are taxed at the enterprise level at the standard 25 percent rate and WHT applies at standard rate of 10 percent on dividends (unless eligible for treaty relief).

— Asset acquisitions may be relatively easier to fund than share acquisitions from a regulatory viewpoint (see the section on choice of acquisition funding later in this report).

— Must reserve profits in a non-distributable capital reserve of up to 50 percent of amount of registered capital.

— May be converted to a joint stock company (company limited by shares) for the purposes of listing on the stock market.

Joint venture

— Joint ventures can be formed by one or more Chinese enterprises together with one or more foreign enterprises or individuals either as an equity joint venture or cooperative joint venture.

— An equity joint venture may be established as a limited liability company. The foreign partners must own at least 25 percent of the equity interest.

— Profits and losses of the equity joint venture must be distributed according to the ratio of each partner's capital contribution, and the tax and corporate law treatment is the same as for wholly foreign-owned enterprises, as described earlier.

— A cooperative joint venture may be established as either a separate legal person with limited liability or as a non-legal person.

— Profits and losses of the cooperative joint venture may be distributed according to the ratio agreed by the joint venture agreement and can be varied over the contract term.

— Where the cooperative joint venture is a separate legal person, the earnings are taxed at the enterprise level at the standard 25 percent rate; otherwise, the earnings are taxed at the investor level.

— WHT applies at a standard rate of 10 percent on dividends (unless eligible for treaty relief) paid by the legal person cooperative joint venture.

— Distributions by the non-legal person variant may not bear WHT, but the joint venture partner of the cooperative joint venture may be exposed to Chinese PE risk. The structure bears similarities to the partnership form (which is increasingly preferred).

Chinese holding company

— A Chinese holding company (CHC) can finance the purchase of a Chinese subsidiary from another group company through a mixture of equity and shareholder debt, in line with the 'debt quota'.

— Permitted to obtain registered capital/loans from abroad to finance equity acquisitions (but cannot borrow domestically to finance equity acquisitions).

— Same tax treatment as wholly foreign-owned enterprises (10 percent WHT (unless eligible for treaty relief), 25 percent CIT on profits and gains) and same corporate law restrictions.

— Dividends paid to a CHC from its Chinese subsidiaries are not subject to CIT or WHT.

— A CHC can reinvest the dividends it receives directly without being deemed to pay a dividend.

— Historically, a CHC is required to have a minimum registered capital of 30 million US dollars (US$). While this requirement has now been officially abolished, it may still apply in practice.

Chinese partnership

— Foreign partners are allowed to invest in Chinese limited partnerships as of March 2010.

— Profits and losses are distributed in accordance with partnership agreement.

— Unlike a corporate entity, there is no capital reserve requirement.

— Taxed on a look-through basis, although there is some uncertainty regarding the taxation of foreign partners.

— For an active business, the foreign partner should be taxed at 25 percent as having a PE in the Chinese, which in effect potentially eliminates the double taxation that arises with regard to dividend WHT in a corporate context.

— Where a partnership receives passive income, it is unclear whether a foreign partner is treated as receiving that income (with potential treaty relief) or as having a PE in the Chinese.

— Uncertainty regarding treatment of tax losses and stamp duty.

Choice of acquisition funding

Generally, an acquiring company may fund an acquisition with equity or a combination of debt and equity. Interest paid or accrued on debt used to acquire business assets may be allowed as a deduction to the payer. Historically, under the State Administration of Foreign Exchange (SAFE) Circular 142, if a Chinese-established entity is used as the acquisition vehicle, the entity may not be allowed to borrow money or obtain registered capital from abroad to fund an equity acquisition in China. This prohibition has been removed by SAFE Circular 19, which was issued in 2015, although it may still need to be observed in practice. Borrowing locally for acquisition is normally not possible because the People's Bank of China (PBOC) generally prohibits lending to fund equity acquisitions (and local banks have limited interest in using the legal exceptions that do exist to lend to foreign invested enterprises). However, a CHC may be in a position to borrow or obtain registered capital from abroad to fund an equity acquisition.

Debt

The amount of foreign debt that Chinese companies can borrow is now subject to a number of new rules issued by the PBOC in the past 24 months.

PBOC issued Yinfa [2016] No.18 (Circular 18) (effective from January 2016) and Yinfa [2016] No.132 (Circular 132, effective from May 2016) to set out the relevant rules (including new foreign debt limits) for Chinese companies borrowing foreign debts with the aim of easing their foreign exchange settlement restrictions. These circulars were superseded by Yinfa [2017] No.9 (Circular 9, effective as of January 2017), which revised the foreign debt limits that were prescribed under Circular 18 and Circular 132.

Under Circular 9, the revised foreign debt limit for various types of Chinese entity are as follows:

— A Chinese company that is neither real estate-related nor a financial institution is limited to 2 times its net asset value

— A Chinese non-banking financial institution is limited to its capital amount (i.e. the amount of paid-in capital or capital stock plus the amount of capital reserve)

— A Chinese banking financial institution is limited to 80 percent of its tier-one capital amount

Circular 9 provides for a 1-year transitional period from the date it was issued (i.e. it expires on 12 January 2018), during which, a foreign invested enterprise (FIE) financial institution and a FIE non-financial institution can opt for the above revised foreign debt limit or remain under the previous foreign debt limit prescribed under the foreign debt management guideline jointly issued by the National Development and Reform Commission (NDRC), MOF and SAFE.

After the end of the 1-year transitional period, FIE financial institutions are mandated to adopt the foreign debt limit prescribed under Circular 9. However, FIE non-financial institutions will have to wait for further clarification from PBOC and SAFE on whether they will follow suit.

Foreign debt limits for CHCs, which are set out in MOC Order [2004] No.22 (Order 22), are normally higher than those for FIEs. Specifically, for a CHC with registered capital of not less than US$30 million, its foreign debt quota is limited to 4 times its paid-up capital. For a CHC with registered capital of not less than US$100 million, its foreign debt quota is limited to 6 times of its paid-up capital.

Further, according to Guofa [2017] No.5 (Notice 5), the minimum registered capital requirement for FIEs have been abolished. However, the relevant government authorities (e.g., NDRC, MOFCOM and the State Administration for Industry and Commerce) have not yet updated their implementation guidance on the requirements for setting up FIE. In practice, the below ratios of registered capital to total investment are still valid:

Registered capital	Registered capital as a percentage of total investment
Equal to or under US$2.1 million	70
Over US$2.1 million but equal to or less than US$5.0 million	50
Over US$5.0 million but equal to or less than US$12.0 million	40
Over US$12.0 million	33

Source: KPMG China, 2018

The foreign debts should be registered with the local SAFE in order for the Chinese companies to remit foreign currency overseas to pay interest or settle the loan principal to the foreign lender(s).

Any related-party loans also need to comply with the arm's length principle under the Chinese transfer pricing rules.

Deductibility of interest

Under the CIT law, non-capitalized interest expenses incurred by an enterprise in the course of its business operations are generally deductible for CIT purposes, provided the applicable interest rate does not exceed applicable commercial lending rates.

The CIT law also contains thin capitalization rules that are generally triggered, for non-financial institutions, when a resident enterprise borrows money from a related party that results in a debt-to-equity ratio exceeding the 2:1 ratio stipulated by the CIT law. Interest incurred on the excess portion is not deductible for CIT purposes. The arm's length principle must be observed in all circumstances.

Where a CHC has been used as the acquisition vehicle, it should have sufficient taxable income (from an active business or from capital gains; dividends from subsidiaries are exempt) against which to apply the interest deduction, as tax losses (created through interest deductions or otherwise) expire after 5 years. Alternative approaches to utilizing the losses are not available as loss grouping is not provided for under the Chinese law. Thus, CHCs generally are not able to merge with their subsidiaries (precluding debt pushdown), and problems may arise for a non-CHC in obtaining a tax-free vertical merger.

Withholding tax on debt and ways to reduce or eliminate it

Payments of interest by a Chinese company to a non-resident without an establishment or place of business in the Chinese are generally subject to WHT at 10 percent. The rate may be reduced under a treaty. Under the VAT reforms implemented for the financial services industry as of 1 May 2016, VAT at 6 percent is levied on interest income earned by non-residents from a Chinese company and the VAT charged is not creditable to the Chinese company.

Under Announcement 60, a taxpayer or its withholding agent is required to submit the relevant documents to the Chinese tax authorities when making the tax filing for accessing treaty benefits (e.g. reduced interest WHT rate). As discussed above, while no pre-approval is required for enjoying the treaty benefits, the tax authorities may conduct post-filing examinations. Where it is discovered that treaty relief should not have applied and tax has been underpaid, the tax authorities will seek to recover the taxes underpaid and may launch anti-avoidance proceedings.

Checklist for debt funding

— Consider whether the application of SAFE and PBOC rules precludes debt financing for foreign investment in the circumstances and in the industry.

— The use of third-party bank debt may mitigate thin capitalization and transfer pricing issues.

— Consider what level of funding would enable tax relief for interest payments to be effective.

— It is possible that a tax deduction may be available at higher rate than the applicable tax on interest income in the recipient's jurisdiction.

— WHT of 10 percent applies to interest payments to non-Chinese entities unless a lower rate applies under the relevant treaty.

Equity

A buyer may use equity to fund its acquisition, possibly by issuing shares to the seller, and may wish to capitalize the target post-acquisition. However, reduction of share capital/share buy-back in a Chinese company may be difficult in certain locations where pre-approval from the relevant Chinese authorities is still required, and the capital reserve rules may cause some of the profits of the enterprise to become trapped. The use of equity may be more appropriate than debt in certain circumstances, in light of the foreign debt restrictions highlighted above and the fact that, where company is already thinly capitalized, it may be disadvantageous to increase borrowings further.

Provided that the necessary criteria are satisfied, Circular 59 provides a tax-neutral framework for structuring acquisitions under which the transacting parties may elect temporarily to defer recognizing the taxable gain or loss arising on the transactions (a qualifying special corporate reorganization).

One of the major criteria for qualifying as a special corporate reorganization is that at least 85 percent of the transaction consideration should be equity consideration (i.e. stock-for-stock or stock-for-assets). Other relevant criteria include:

— The transaction is motivated by reasonable commercial needs, and its major purpose is not achieving tax avoidance, reduction, exemption or deferral.

— The assets/equity that are transferred are equal to at least 50 percent of the respective total asset of the transferor/total equity of the transferred enterprise.

— The operation of the reorganized assets will not change materially within a consecutive 12-month period after the reorganization.

— Original shareholders receiving consideration in the form of shares should not transfer such shareholding within a 12-month period after the reorganization.

For qualifying special corporate reorganizations, the tax deferral is achieved through the carryover to the transferee of tax bases in the acquired shares or assets but only to the extent of that part of the purchase consideration comprising shares. Gains or losses attributable to non-share consideration, such as cash, deposits and inventories, are recognized at the time of the transaction.

In addition to the relief under Circular 59, Circular 109 introduced a new condition for STT that permits elective non-recognition of income on transfer of assets/equity between two Chinese TREs that are in a '100 percent holding relationship', provided no accounting gains/losses are recognized. Both the purpose test and the continuing business test in Circular 59 hold, and the tax basis of transferred assets for future disposal is their original tax basis.

Certain cross-border reorganizations need to meet conditions in addition to those described earlier to qualify for the special corporate reorganization, including a 100 percent shareholding relationship between the transferor and transferee when inserting an offshore intermediate holding company.

SAT Announcement [2013] No. 72 (Announcement 72) addresses situations where a cross-border reorganization involves the transfer of the Chinese enterprise from an

offshore transferor that does not have a favorable dividend WHT rate to an offshore transferee that has a favorable dividend WHT rate with China. Announcement 72 clarifies that the retained earnings of the Chinese enterprise accumulated before the transfer are not entitled to any reduction in the dividend WHT rate even if the dividend is distributed after the equity transfer reorganization. This measure is designed to prevent any dividend WHT advantages for profits derived before a qualifying reorganization.

Share capital reductions are possible but difficult in certain locations where the pre-approval from the relevant Chinese authorities is still required. As Chinese corporate law only provides for one type of share capital, it is not possible to use instruments such as redeemable preference shares. Where a capital reduction was to be achieved and was to be financed with debt, in principle, it is possible to obtain a tax deduction for the interest.

Hybrids

Consideration may be given to hybrid financing, that is, using instruments treated as equity for accounts purposes by one party and as debt (giving rise to tax-deductible interest) by the other. In light of the OECD's anti-BEPS recommendations on hybrid mismatch arrangements, this may become more difficult in the future. There are currently no specific rules or regulations that distinguish between complex equity and debt interest for tax purposes under Chinese tax regulations.

Generally, the definitions of share capital and dividends for tax purposes follow their corporate law definitions, although re-characterization using the GAAR in avoidance cases is conceivable. In practice, hybrids are difficult to implement in China, particularly in a cross-border context. China's restrictive legal framework currently does not provide for the creation of innovative financial instruments that straddle the line between debt and equity.

Other considerations

Company law

Chinese company law prescribes how the Chinese companies may be formed, operated, reorganized and dissolved.

One important feature of the law concerns the ability to pay dividends. A Chinese company is only allowed to distribute dividends to its shareholders after it has satisfied the following requirements:

— The registered capital has been fully paid-up in accordance with the articles of association.

— The company has made profits under Chinese GAAP (i.e. after utilizing the accumulated tax losses from prior years, if any).

— CIT has been paid by the company, or the company is in losses or in a tax exemption period.

— The statutory after-tax reserve funds (e.g. general reserve fund, enterprise development fund and staff benefit and welfare fund) have been provided.

For corporate groups, this means the reserves retained by each company, rather than group reserves at the consolidated level. Regardless of whether acquisition or merger accounting is adopted in the group accounts, the ability to distribute the pre-acquisition profits of the acquired company may be restricted, depending on the profit position of each company.

Where M&A transactions are undertaken, the MOC rules in Provisions on the Acquisition of Domestic Enterprises by Foreign Investors (revised), issued in 2009, should be considered. Also bear in mind the national security review regulations issued by MOC in March 2011, which affect foreign investment in sectors deemed important to national security. The consent of other authorities, such as the State Administrations of Industry and Commerce, and specific sector regulators, such as the China Securities Regulatory Commission, may also be needed.

Group relief/consolidation

There are currently no group relief or tax-consolidation regulations in the Chinese.

Transfer pricing

Where an intercompany transaction occurs between the buyer and the target following an acquisition, any failure to conform with the arm's length principle might give rise to transfer pricing issues in China. Under the Chinese transfer pricing rules, the tax authorities are empowered to make tax adjustments within 10 years of the year during which the transactions took place and recover any underpaid Chinese taxes. These regulations are increasingly rigorously enforced.

Dual residency

There are currently no dual residency regulations in the Chinese.

Foreign investments of a local target company

China's CFC legislation is designed to prevent Chinese companies from accumulating offshore profits in low-tax countries. Under the CFC rules, where a Chinese resident enterprise by itself, or together with individual Chinese residents, controls an enterprise that is established in a foreign country or region where the effective tax burden is lower than 50 percent of the standard CIT rate of 25 percent (i.e. 12.5 percent) and the foreign enterprise does not distribute its profits or reduces the distribution of its profits for reasons other than reasonable operational needs, the portion of the profits attributable to the Chinese resident enterprise is included in its taxable income for the current period. Where exemption conditions under the rules are met, the CFC rules would not apply.

Comparison of asset and share purchases

Advantages of asset purchases

— Purchase price may be depreciated or amortized for tax purposes and the buyer gains a step-up in the tax basis of assets.

— Buyer usually does not inherit previous liabilities of the company.

— No acquisition of a historical tax liability on retained earnings.

— Possible for the buyer to acquire part of a business only.

— Deduction for trading stock acquired.

— Profitable operations can be absorbed by a loss-making company if the loss-making company is used as the buyer.

— May be easier to obtain financing from a regulatory perspective.

Disadvantages of asset purchases

— Buyer needs to renegotiate the supply, employment and technology agreements.

— Government licenses pertaining to the seller are not transferable.

— May be unattractive to the seller (high transfer tax costs to the seller if the value of the assets has appreciated substantially, particularly if the assets include immovable properties), thus increasing the purchase price.

— It may be time-consuming and costly to transfer assets.

— Accounting profits and thus the ability to distribute profits of the acquired business may be affected by the creation of acquisition goodwill.

— Benefit of any tax losses incurred or tax attributes/ incentives obtained by the target company remains with the seller.

Advantages of share purchases

— Purchaser may benefit from existing government licenses, supply contracts and technology contracts held by the target company.

— The transaction may be easier and take less time to complete.

— Less transactional tax usually arises.

— Lower outlays (purchase of net assets only).

Disadvantages of share purchases

— Purchaser is liable for any claims or previous liabilities of the target company.

— More difficult regulatory environment for financing equity acquisitions.

— No deduction for purchase price and no step-up in cost base of underlying assets of the company.

— Latent tax exposures for buyer (unrealized gains on assets), which could be significant if the underlying assets include immovable properties.

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Hong Kong (SAR)

Introduction

Hong Kong (SAR) is a former British Crown Colony whose sovereignty was returned to the People's Republic of China (PRC) on 1 July 1997. The Hong Kong (SAR) government has traditionally adopted a minimal intervention approach to the economy.

Consistent with this approach, Hong Kong (SAR) has a relatively simple tax system, minimal competition law, a relatively unregulated business environment and practically no restrictions on foreign ownership. There are no exchange controls and limited restrictions on repatriation of profits.

The Basic Law, which came into effect on 1 July 1997, ensures the continuation of Hong Kong (SAR)'s capitalist economy and way of life for 50 years. The Basic Law is a constitutional document for the Hong Kong Special Administrative Region (SAR) that enshrines the important concepts of one country, two systems, a high degree of autonomy and Hong Kong (SAR) people ruling Hong Kong (SAR). The laws previously in force in Hong Kong (SAR) (common law, rules of equity, ordinances, subordinate legislation and customary law) were maintained, except for those that contravened the Basic Law and subject to any amendments made by the Hong Kong (SAR) legislature. Consistent with the Basic Law, Hong Kong (SAR) continues to maintain its own tax system, which is separate from the PRC's, the tax laws of which do not apply to the Hong Kong (SAR).

Recent developments

The major tax changes in Hong Kong (SAR) since the last edition of this report are as follows:

— Hong Kong (SAR) has now concluded 38 tax treaties, including double tax agreements with Belarus, Latvia and Pakistan (which all entered into force in 2017) and with Saudi Arabia (subject to ratification on both sides).

— Draft legislation has been introduced to extend the profits tax exemption for offshore investment funds to onshore privately offered open-ended fund companies.

— A two-tiered profits tax regime has been introduced under which the tax rate for the first 2 million Hong Kong dollars (HKD) of profits will be lowered to half of the standard profits tax rate.

— Draft legislation has been introduced in Hong Kong (SAR) for mandatory transfer pricing reporting and to address base erosion and profit shifting (BEPS).

Asset purchase or share purchase

In Hong Kong (SAR), it is more common for an acquisition to take the form of a purchase of shares of a company as opposed to a purchase of its business and assets.

Persons (which include a corporation, partnership, trustee, whether incorporated or unincorporated, or body of persons) are only subject to profits tax on their profits arising in or derived from Hong Kong (SAR) from a trade, profession or business carried on in Hong Kong (SAR), except for any profits realized from sales of capital assets, which are exempt from profits tax. Sellers frequently are able to dispose of investments in shares free of profits tax.

By contrast, sales of certain assets may trigger a recapture of capital allowances claimed and possibly higher transfer duties (depending on the assets involved). These factors are likely to make asset acquisitions less attractive for the seller. However, the benefits of asset purchases should not be ignored, in particular, the potential to obtain deductions for the financing costs incurred on funds borrowed to finance the acquisition of business assets.

Some of the tax considerations relevant to each type of acquisition structure are discussed later in this report. The advantages and disadvantages are summarized at the end of the report.

Purchase of assets

For tax purposes, it is generally advisable for the purchase agreement to specify a commercially justifiable allocation of the purchase price among the assets, because all or part of the purchase price payable by a buyer may be eligible for tax relief in the form of capital allowances or deductions (either outright or over time), depending on the types of assets involved.

Tax-depreciation allowances arising from capital expenditure incurred on the acquisition of plant and machinery are generally computed with reference to the amount

actually paid by the purchaser to the seller. However, the Commissioner of Inland Revenue (CIR) may apply discretion where an asset that qualifies for initial or annual allowances is sold and the buyer is a person over whom the seller has control or vice versa, or both the seller and the buyer are persons over whom some other person has control. In this case, if the CIR considers that the selling price is not representative of the asset's true market value at the time of sale, the CIR is authorized to determine the true market value of the asset sold. The value so determined is used to compute the balancing allowance or balancing charge for the seller and the capital expenditure of the buyer on which initial and annual allowances may be claimed.

For commercial and industrial buildings and structures, the tax allowances are based on the 'residue of expenditure' immediately after the sale. The residue of expenditure is the amount of capital expenditure incurred in the construction of the building or structure, reduced by any initial, annual or balancing allowances that have already been granted or any notional amounts written off and increased by any balancing charges made when the building or structure was previously used as an industrial or commercial building or structure.

Goodwill

The portion of the purchase price representing the cost of acquiring goodwill is not deductible for profits tax purposes. Where certain conditions are met, the Inland Revenue Ordinance (IRO) provides for the following specific deductions for payments giving rise to intangible assets:

— Sums expended for registering a trademark, design or patent used in the trade, profession or business that produces chargeable profits payments for and expenditure incurred on research and development (R&D); in particular, payments to an approved research institute for R&D that may be specific to the requirements of the trade, profession or business or merely within that class of trade, profession or business; and expenditure on R&D, including capital expenditure, other than expenditure on the acquisition of land including capital expenditure, other than expenditure on the acquisition of land or buildings or alterations, additions or extensions to building.

— Expenditure incurred on the purchase of patent rights or rights to any knowhow for use in Hong Kong (SAR) (except where purchased from an associate).

— Write-off of expenditure incurred on the purchase of copyrights, registered designs or registered trademarks over 5 years.

The Hong Kong (SAR) government has also proposed to introduce a super tax deduction for R&D expenditure that would allow a 300 percent tax deduction for the first HKD2 million of qualifying R&D expenditure and a 200 percent tax deduction for remaining expenditure.

Depreciation

The IRO grants initial and annual depreciation allowances on capital expenditure incurred in acquiring or constructing industrial buildings, commercial buildings and plant and machinery used in the production of assessable profits. The rates applicable for the 2017/18 year of assessment are as follows:

Type of asset	Initial allowance	Annual allowance
Industrial buildings	20 percent of qualifying expenditure	4 percent of qualifying expenditure
Commercial buildings	Zero	4 percent of qualifying expenditure
Plant and machinery	60 percent of qualifying expenditure	10, 20 or 30 percent of the tax written-down value, depending on the category of asset

In addition, the IRO provides the following tax concessions:

— write-off of certain expenditure incurred on the refurbishment or renovation of a building or structure in equal installments over 5 years

— write-off of certain expenditure incurred on the construction of an environmental protection installation in equal installments over 5 years and a 100 percent write-off of environmental protection machinery

— subject to certain provisions, 100 percent write-off of computer software, computer systems and computer hardware that are not an integral part of any machinery or plant, and certain other qualifying machinery or plant used specifically and directly in the manufacturing process.

Balancing charges or allowances may be triggered on specified occasions related to the cessation of use by the claimant having the relevant interest in a building or structure (e.g. when the building or structure has been demolished, destroyed or ceases to be used by the claimant). For qualifying plant and machinery, the sales proceeds (limited to cost) are deducted from the reducing value of the relevant pool. A balancing charge arises when, at the end of the basis period for a year of assessment, the reducing value of the pool is negative. Any excess of the sales proceeds above the original cost of the plant and machinery is not subject to profits tax. Such excess should be regarded as a profit arising from the sale of a capital asset.

Tax attributes

Tax losses are not transferred on an asset acquisition. The benefit of any tax losses incurred by the seller company remains with the seller (subject to an increase or reduction by the amount of any balancing charges or allowances on the sale of any depreciable assets).

Hong Kong (SAR) does not have a franking or imputation regime.

Value added tax

There is currently no goods and services tax (GST) or value added tax (VAT) in Hong Kong (SAR).

Transfer taxes

Stamp duty is imposed on certain instruments dealing with the sale or transfer of immovable property situated in Hong Kong (SAR). 'Immovable property' is defined as land, any estate, right, interest or easement in or over any land, and things attached to land (e.g. buildings) or permanently fastened to anything attached to land.

As of 5 November 2016, the ad valorem stamp duty rates for the transfer of residential property were increased to a flat rate of 15 percent irrespective of the amount or value of consideration of the residential property concerned, unless specifically exempt or otherwise provided. For the transfer of non-residential property, the ad valorem stamp duty rates range from 1.5 percent on consideration of up to HKD2 million to up to 8.5 percent on consideration of more than HKD21.7 million. A lease of immovable property in Hong Kong (SAR) is chargeable to ad valorem stamp duty on a progressive scale ranging from 0.25 percent of average annual rent, where the term of the lease is uncertain, to 1 percent of average annual rent where the lease term exceeds 3 years.

A special stamp duty (SSD) is effective for residential properties acquired on or after 20 November 2010 and resold within 24 months. SSD applies in addition to the ad valorem rates of stamp duty already imposed. SSD is imposed on the full value of sales proceeds at penal rates of 5, 10 or 15 percent, depending on when the property is bought and sold.

As of 27 October 2012, the rates of SSD were increased for residential properties acquired on or after 27 October 2012 and range from 10 to 20 percent, depending on the holding period, which has been extended to 36 months.

A buyer's stamp duty (BSD) on residential properties took effect from 27 October 2012. Any residential property acquired by any person (including an incorporated company), except that of a Hong Kong (SAR) permanent resident, is subject to BSD. BSD is charged at a flat rate of 15 percent on all residential properties, on top of the existing stamp duty and SSD, if applicable.

The Stamp Duty Ordinance (SDO) provides that a sale or transfer of immovable property from one associated corporate body to another is exempt from stamp duty. Two companies are associated where:

— one is the beneficial owner of not less than 90 percent of the issued share capital of the other, or

— a third company owns not less than 90 percent of the issued share capital of each company.

In addition to the 90 percent association test, a number of other conditions need to be satisfied to qualify for stamp duty exemption. There is a claw back rule in cases where the 90 percent association test ceases to be satisfied within 2 years of the date of the transfer.

Purchase of shares

Tax indemnities and warranties

It is not currently possible to obtain a clearance from the Inland Revenue Department (IRD) giving assurance that a potential target company has no arrears of tax or advising whether the company is involved in a tax dispute. As a result, it is common for tax indemnities or warranties to be included in sale and purchase agreements. The extent of the tax indemnities or warranties is subject to negotiation between the seller and the purchaser and it is customary for prospective purchasers to undertake a tax due diligence review to ascertain the tax position of the target company and to identify potential tax exposures.

Tax losses

Generally, tax losses incurred by a Hong Kong (SAR) taxpayer may be carried forward indefinitely for set-off against the assessable profits earned in subsequent years of assessment. Losses may not be carried back.

There is no group relief in Hong Kong (SAR). Each company is treated as a separate person for tax purposes. Any unused tax losses incurred by the seller company cannot be transferred to the purchasing company on the sale of the business or the assets of the seller company. A sale of shares in the Hong Kong (SAR) company usually does not affect the availability of the tax losses to be carried forward by that company, unless the change in the company's shareholders is effected for the sole or dominant purpose of using the Hong Kong (SAR) company's tax losses.

In the context of court-free amalgamations, the IRD's current position is that pre-amalgamation tax losses sustained in an amalgamating company would be available to offset the profits derived from the 'same trade or business' that the amalgamating company previously carried on and is continued by the amalgamated (surviving) company after amalgamation. Further, tax losses brought forward in the amalgamated company can be offset against profits derived from the trade or business succeeded from the amalgamating company, provided the amalgamated company has fulfilled certain conditions, including the financial resources test, trade continuation test and post-entry test.

Crystallization of tax charges

Changes in the shareholding of a Hong Kong (SAR) company do not trigger any tax charges. The impact of changes in shareholding on tax losses is discussed in the preceding paragraph.

Transfer taxes

Hong Kong (SAR) stamp duty is chargeable on instruments effecting the sale or transfer of Hong Kong (SAR) stock. 'Hong Kong (SAR) stock' is defined to include shares in Hong Kong (SAR)-incorporated companies as well as shares in overseas-incorporated Hong Kong (SAR)-listed companies whose transfer of shares has to be registered in Hong Kong (SAR). No stamp duty is payable on allotments of shares, and capital duty was abolished as of 2013.

The current prevailing stamp duty rate is an aggregate amount equal to 0.2 percent (0.1 percent payable each on the buy note and the sell note) on the higher of the actual consideration stated in the relevant instrument or the value of the stock as at the transfer date, plus a fixed duty of HKD5 for stamping the instrument of transfer. For unlisted Hong Kong (SAR) stock, the value is generally determined by reference to the latest accounts of the company whose shares are being transferred. The net assets and liabilities of the company per the latest accounts are used as the starting point, with possible adjustments to reflect the assets' market value as at the date of transfer.

A specific stamp duty anti-avoidance provision may apply where shares in a target company change hands and an arrangement is made between the parties so that the purchaser is required to refinance, guarantee or otherwise assume liability for the target company's debt. For example, where A sells shares in the target company to B and, as an integral part of the transaction, A assigns to B the shareholder's loan due by the target, the money paid by B as consideration for the assignment of the loan is deemed to be part of the consideration for the sale and purchase of the shares.

As with immovable property, the SDO provides that a transfer of shares from one associated corporate body to another is exempt from stamp duty. As noted earlier in the report, two companies are associated where one is the beneficial owner of not less than 90 percent of the issued share capital of the other, or a third company owns not less than 90 percent of the issued share capital of each company. In addition to the 90 percent association test, a number of other conditions need to be satisfied to qualify for this exemption. A clawback rule applies where the 90 percent association test ceases to be satisfied within 2 years from the date of the transfer.

Pre-sale dividend

In certain circumstances, a pre-sale dividend may be considered to reduce the value of the company for Hong Kong (SAR) stamp duty purposes.

Tax clearances

A person may apply to the CIR for an advance ruling on how any provision of the IRO applies to them or the arrangement specified in the application. An application fee is payable, and limitations apply.

It is not currently possible to obtain a clearance from the IRD giving assurance that a potential target company has no arrears of tax or advising as to whether the company is involved in a tax dispute.

Choice of acquisition vehicle

As Hong Kong (SAR) operates a territorial system of taxation, the profits tax rules apply equally to Hong Kong (SAR) incorporated companies carrying on a trade or business in Hong Kong (SAR) and overseas incorporated companies carrying on a trade or business in Hong Kong (SAR) through a branch. The main types of investment vehicles used to carry on business in Hong Kong (SAR) are a Hong Kong (SAR) incorporated company, a branch of a foreign company, a partnership and an unincorporated joint venture. The local registration and administration requirements vary, depending on the form of legal presence used.

The tax rates that apply to a person's assessable profits to determine their profits tax liability for the 2017/18 year of assessment are as follows:

— for corporations: 16.5 percent

— for unincorporated businesses: 15 percent.

The Hong Kong (SAR) government has issued draft legislation introducing a two-tiered profits tax regime, which will apply to both corporations and unincorporated business. Under this regime, the tax rate for the first HKD2 million of profits will be reduced to half of the standard profits tax rate (i.e. 8.25 percent for corporations and 7.5 percent for unincorporated businesses). The remaining profits will be taxed at the standard tax rates.

Under an anti-avoidance measure, a 'group of connected entities' can only nominate one entity within the group to enjoy the reduced tax rate for a given year of assessment. The two-tier system is expected to have effect from the year of assessment 2018/19 (i.e. periods starting on or after 1 April 2018), subject to enactment by the Legislative Council.

Hong Kong (SAR) has concluded comprehensive tax treaties with the following countries/jurisdictions:

Austria	Japan	Portugal
Belarus	Jersey	Qatar
Belgium	Korea	Romania
Brunei	Kuwait	Russia
Canada	Latvia	Saudi Arabia
China (People's Republic)	Liechtenstein	South Africa
Czech Republic	Luxembourg	Spain
France	Malaysia	Switzerland
Guernsey	Malta	Thailand
Hungary	Mexico	United Arab Emirates
Indonesia	Netherlands	United Kingdom
Ireland	New Zealand	Vietnam
Italy	Pakistan	

Negotiations to conclude tax treaties with a number of Hong Kong's (SAR) trading and investment partners are underway. Hong Kong (SAR) also has non-comprehensive treaties with various countries relating to income derived from the

international operation of ships and/or aircraft. Details and dates of tax treaty negotiations are published on the IRD's website.

For a summary of reduced withholding tax (WHT) rates under Hong Kong's (SAR) tax treaties, see the table at the end of this report.

Foreign parent company

From a Hong Kong (SAR) tax perspective, a foreign parent company may choose to make direct inbound investments into Hong Kong (SAR) since dividends paid by a Hong Kong (SAR) company to a non-resident shareholder are not subject to WHT in Hong Kong (SAR).

Non-resident intermediate holding company

From a Hong Kong (SAR) tax perspective, it may not be necessary to set up a foreign intermediate holding company for inbound investments into Hong Kong (SAR) since dividends paid by a Hong Kong (SAR) company to a non-resident shareholder are not subject to WHT in Hong Kong (SAR).

Local branch

A foreign purchaser may decide to acquire business assets through a Hong Kong (SAR) branch. For example, it is common for companies incorporated in the British Virgin Islands to be used to carry on business in Hong Kong (SAR). Alternatively, it may be possible for non-Hong Kong (SAR)-sourced income earned through the Hong Kong (SAR) branch to benefit from protection under a tax treaty concluded between the jurisdiction in which the head office is located and the jurisdiction where the relevant income is sourced.

Hong Kong (SAR) does not impose additional taxes on branch profits remitted to an overseas head office. Generally, Hong Kong's (SAR) profits tax rules apply to foreign persons carrying on business in Hong Kong (SAR) through a branch in the same way that they apply to Hong Kong (SAR)-incorporated entities. There are special rules for ascertaining the assessable profits of a branch and those of certain types of businesses, including ship owners carrying on business in Hong Kong (SAR) and non-resident aircraft owners.

Joint venture

Partners in a general partnership are jointly and severally liable for the debts and obligations incurred by them or on their behalf. A partnership is treated as a chargeable person for profits tax and property tax purposes, so tax is chargeable at the partnership level. Although a partnership is assessed as a separate legal entity for profits tax purposes, the amount of its liability to profits tax is determined by aggregating the tax liabilities of each partner with respect to their share of the assessable profits or losses of the partnership. Therefore, the amount of tax payable on the partnership profits is affected by the tax profiles of the individual partners, that is, whether the partners have losses and whether the partners are corporate entities (such that the profits tax rate of 16.5 percent applies for the 2017/18 year of assessment) or individuals (such that the standard salaries tax rate of 15 percent applies for the 2017/18 year of assessment).

By contrast, a joint venturer is not responsible in law for acts of its co-venturers. A joint venture is not a legal person and is not deemed to be a chargeable person for the purposes of the IRO. In practice, a profits tax return is often issued by the IRD under the name of the joint venture.

Provided that the IRD accepts that the joint venture should not be regarded as a partnership, it is usually sufficient for the profits tax return to be completed and filed on a nil basis. The relevant income and expenses of the joint venture is reported in the joint venturers' own profits tax returns.

Choice of acquisition funding

Debt

Hong Kong (SAR) does not impose capital taxes on the issue of debt. There are no transaction taxes or other similar charges on the payment or receipt of interest. Some forms of debt may fall within the definition of Hong Kong (SAR) stock for stamp duty purposes.

Deductibility of interest

Generally, for borrowers other than financial institutions, loan interest and related expenditure (e.g. legal fees, procurement fees, stamp duties) are deductible only to the extent that the money is borrowed for the purpose of producing assessable profits of the borrower and one of the following tests is satisfied:

1. The money is borrowed from a person other than a financial institution or an overseas financial institution, and the interest payable is chargeable to profits tax for the recipient.
2. The money is borrowed from a financial institution or an overseas financial institution, and the repayment of principal or interest is not secured or guaranteed in whole or in part, and, whether directly or indirectly, by any instrument executed against a deposit made by any person where interest on that deposit or loan is not chargeable to profits tax.
3. The money is borrowed to finance:
   - capital expenditure incurred in the provision of machinery or plant that qualifies for depreciation allowances for profits tax purposes
   - the purchase of trading stock used by the borrower in the production of profits chargeable to profits tax, provided the lender is not an associate of the borrower.
4. The funds are raised by way of listed debentures or certain other marketable instruments.

For the first and third tests, the IRO contains provisions to counter sub-participation and back-to-back loan arrangements by which, the IRD asserts, Hong Kong (SAR) taxpayers were previously able to circumvent the conditions in and thwart the legislative intent of these provisions:

— **Tax symmetry test**: This test precludes a borrower from deducting interest on a loan secured by either a deposit or a loan made by the Hong Kong (SAR) borrower (or an associate) where the interest on the loan or deposit is not subject to profits tax. Where the loan is partly secured by tax-free deposits or loans, the interest deduction is apportioned on the most reasonable and appropriate basis, given the circumstances of the case.

— **Interest flow-back test**: Under this test, interest is not deductible where an arrangement between the borrower and the lender stipulates that the interest is ultimately paid back to the borrower or a person connected with the borrower. A 'connected person' is defined as an associated corporation or a person who controls the borrower, is controlled by the borrower, or is under the same control as the borrower. However, a partial deduction for the interest is permitted when the interest only partially flows back to the borrower and only in proportion to the number of days during the year in which the flow-back arrangement is effective. The test does not apply where the interest is payable to an 'excepted person', which is defined to include a person who is subject to profits tax in Hong Kong (SAR) on the interest, a financial institution (domestic or overseas), a retirement fund or collective investment fund in which the borrower or an associate has an interest, and a government-owned corporation.

In addition to these specific conditions for interest and related borrowing costs, funding costs and related expenses must be properly charged to the profit and loss account in the basis period for the year of assessment and not otherwise be of a capital nature in order to qualify for deduction.

Following the Court of Final Appeal's decision in *Zeta Estates Ltd v Commissioner of Inland Revenue* (2007) 2 HKIRD 102, it is now possible for acquirers to achieve debt pushdown by borrowing to replace equity funding with debt funding (e.g. by paying a dividend), where the equity is employed as capital or working capital in a business carried on for the purpose of earning assessable profits.

Withholding tax on debt and methods to reduce or eliminate it

Hong Kong (SAR) does not currently impose WHT on interest paid by persons carrying on a trade, profession or business in Hong Kong (SAR).

Checklist for debt funding

— There are no limits on the level of debt funding because Hong Kong (SAR) has no thin capitalization rules. However, the restrictive circumstances in which tax relief is granted for interest and related financing costs may influence the amount and source of any debt funding introduced to make an acquisition.

— Interest and financing costs incurred on money borrowed to finance the acquisition of shares are not deductible for profits tax purposes.

— Hong Kong (SAR) has a relatively low profits tax rate, so it is possible that a tax deduction may be available at higher rates in other jurisdictions.

— Hong Kong (SAR) does not currently impose WHT on interest paid by persons carrying on a trade, profession or business in Hong Kong (SAR).

Equity

Capital duty on the increase in the authorized share capital of a company formed and registered under the Hong Kong (SAR) Companies Ordinance was abolished as of 1 June 2012.

Hybrids

Hong Kong (SAR) outbound investors generally do not use hybrid financing because it is relatively easy for non-financial lenders to ensure that any interest income is offshore-sourced.

Hong Kong (SAR) companies need to satisfy the conditions explained in this report's earlier section on deductibility of interest to be eligible to claim a deduction for amounts payable on hybrid instruments.

There are currently no specific provisions under the IRO that distinguish between equity and debt interests for profits tax purposes. However, the IRD has issued a practice note to address the changes in the accounting presentation of debt and equity instruments as required under Hong Kong Accounting Standards (HKAS) 32 and 39. These accounting standards, issued by the Hong Kong Institute of Certified Public Accountants in May 2004, are virtually identical to International Accounting Standards (IAS) 32 and 39, issued by the International Accounting Standards Board. These accounting standards deal with the presentation, recognition and measurement of financial instruments.

The IRD takes the view that the legal form, rather than the accounting treatment, should determine the nature of the financial instrument for profits tax purposes. Therefore, if the characterization of the financial instrument as liability or equity for accounting purposes is not consistent with the legal nature of the instrument, it is necessary to take into account other factors, such as:

— the character of the return (e.g. whether fixed rate or profit participation)

— the nature of the holder's interest in the issuer company (e.g. voting rights and rights on winding up)

— the existence of a debtor and creditor relationship

— the characterization of the instrument by general law.

For example, coupons on mandatory redeemable preference shares are treated as dividends for profits tax purposes and are not as deemed interest, even where the coupons are

re-characterized as interest in the profit and loss account for accounting purposes.

Compound financial instruments must be split into their liability and equity components for purposes of HKAS 32. The IRD adheres to the legal form of the compound instrument and treats it for profits tax purposes as a whole. For example, a convertible bond that is required to be split into its equity and debt components in accordance with HKAS 32 is treated as debt for profits tax purposes. The corresponding interest payments are allowed as deductions provided the general and specific conditions for interest deductibility set out in the IRO are met (see this report's section on debt).

HKAS 39 was replaced by the new accounting standard HKFRS 9 as of 1 January 2018. The IRD has not yet commented on the tax treatment of financial instruments following the implementation of HKFRS 9.

To provide greater certainty, it is possible to obtain an advance ruling from the IRD on the interpretation of statutory provisions in certain circumstances. A ruling may be granted on how any provision of the IRO applies to the applicant or to the arrangement described in the application. A ruling is given only for a seriously contemplated transaction and not for hypothetical transactions or those where the profits tax is due and payable. An advance ruling is not granted once the due date for filing of the relevant year's profits tax return has passed.

Discounted securities

There are currently no specific provisions under the IRO that deal with the tax treatment of discounted securities for profits tax purposes. The IRD takes the view that the legal form, rather than the accounting treatment, should determine the nature of the financial instrument for profits tax purposes (see this report's section on hybrids). Where the characterization of the discount security for accounting purposes is not consistent with the legal nature of the instrument, it is necessary to take into account other factors, such as the factors noted in the preceding section for characterizing hybrid financial instruments.

Where the legal characterization of the discount on the security is interest, then such amount is deductible, provided the IRO's general and specific conditions for interest deductibility are met (see deductibility of interest). Where the legal characterization of the discount is not interest, then its deductibility is determined in accordance with Hong Kong (SAR)'s general deductibility rules.

Deferred settlement

Payments made pursuant to earn-out clauses that result in additional payments or refunds of the purchase price have the same character for tax purposes for the vendor as the initial purchase price. Likewise, payments related to indemnities or warranties that result in an adjustment to the purchase price should have the same character for tax purposes for the vendor as the initial purchase price.

Where interest is payable under the settlement arrangement, such interest is taxable where the recipient carries on business in Hong Kong (SAR) and where such interest has a source in Hong Kong (SAR). The deductibility of the interest to the payer is governed by the principles discussed earlier (see 'Deductibility of interest').

Other considerations

Concerns of the seller

Considerations of the seller can include:

— possible recapture of capital allowances

— stamp duty implications of a transaction

— scope of tax warranties and indemnities in the sale and purchase agreement.

Company law

The Hong Kong Companies Ordinance prescribes how Hong Kong (SAR) companies may be formed, operated and terminated.

The Companies Ordinance, which was passed by the Hong Kong Legislative Council in July 2012 and took effect on 3 March 2014, aims to modernize the law, ensure better regulation, enhance corporate governance and facilitate business.

Under the Companies Ordinance, five types of companies can be formed (compared with eight under the previous ordinance). Unlimited companies without share capital are abolished; companies limited by guarantee, whether private or non-private, are amalgamated and become companies by guarantee; and non-private companies become 'public companies'. The concept of par value of shares is abolished, and a general court-free procedure based on a solvency test is introduced as an alternative to reduction of capital.

Further, the Companies Ordinance makes available a court-free regime for two types of amalgamations of wholly owned companies within the same group:

— vertical amalgamation of a holding company and its wholly owned subsidiaries

— horizontal amalgamation of wholly owned subsidiaries of a company.

The Companies Ordinance makes no mention of the tax implications of a court-free amalgamation. Pending the decision to amend provisions in the IRO to specifically address the tax treatment of court-free amalgamations, on 16 December 2016, the IRD published guidance on its website clarifying its approach when making assessments on the profits tax consequences of a court-free amalgamation, for example, in relation to the availability of unutilized tax losses of the amalgamating companies (see 'Tax losses' above).

All Hong Kong (SAR) companies, other than certain dormant companies, must compile accounts annually and have them audited by a registered Hong Kong (SAR) auditor. However, Hong Kong (SAR) private companies do not have an obligation to file financial statements with the Hong Kong Companies registry or otherwise make them publicly available.

The Companies Ordinance only permits the payment of dividends from distributable profits. A company's profits available for distribution are its accumulated realized profits (not previously used by distribution or capitalization), less its accumulated realized losses (not previously written-off in a reduction or reorganization of capital). The assessment of available profit and declaration of dividends is determined separately for each legal entity, not on the consolidated position. This entity-by-entity assessment requires planning to avoid dividend traps — the inability to stream profits to the ultimate shareholder — because of insufficient profits within a chain of companies. Appropriate pre-acquisition structuring should help to minimize this risk.

A Hong Kong (SAR) company may undergo a court-free share capital reduction if approved by a special resolution supported by a solvency statement based on a uniform solvency test.

Group relief/consolidation

There is no concept of grouping for tax purposes in Hong Kong (SAR). All companies are assessed separately, irrespective of whether they are group, associated or related companies.

Transfer pricing

Hong Kong's (SAR) transfer pricing provisions in the domestic law are brief and address transactions between a resident and a closely connected non-resident. Due to practical difficulties, in the past, these provisions were not commonly applied other than in blatant avoidance cases. Rather, where the IRD encounters non-arm's length pricing, it usually sought to address the situation by adjusting deduction claims or applying the general anti-avoidance provision.

However, the tax and transfer pricing landscape in Hong Kong (SAR) is maturing rapidly, showing signs of keeping up with the advancing transfer pricing recommendations issued by the Organisation for Economic Co-operation and Development (OECD) with the issuance of Departmental Interpretation and Practice Note No. 46 (DIPN-46) by the IRD. The recent change in the transfer pricing environment makes it clear that the IRD is adopting and enforcing transfer pricing principles in tax audits.

According to Hong Kong (SAR) transfer pricing guidelines (i.e. DIPN 46), taxpayers are encouraged to prepare transfer pricing documentation to support the reasonableness of their transfer pricing policy. Although the preparation of a transfer pricing report is not mandatory in Hong Kong (SAR), the IRD recently launched a large number of tax audits against multinationals of different industries, and, in various cases, challenged transfer pricing methodologies.

International companies have come under considerable scrutiny, particularly regarding management service fees and head office charges, including investigations on whether service charges can be supported. The level of details and sophistication of information requested in relation to allocation recharges from the head office and service companies is elevating transfer pricing to a new level in Hong Kong (SAR). This includes scrutiny regarding the benefits test, duplication and support for mark-ups.

Regarding the OECD's BEPS Action Plan, the Hong Kong (SAR) government has introduced draft legislation for mandatory transfer pricing reporting and anti-BEPS measures in Hong Kong (SAR). The bill was gazetted on 29 December 2017. In line with many OECD jurisdictions, the transfer pricing legislation would broadly:

— codify transfer pricing principles and required practices, providing a clear legal basis for transfer pricing and increasing clarity and certainty for taxpayers

— introduce transfer pricing rules that align the taxation of profits with economic activities and value creation

— introduce requirements to prepare and maintain contemporaneous transfer pricing documentation along with reporting requirements that are expected to include three-tier transfer pricing documentation (i.e., master file, local file and, where relevant, Country-by-Country reporting)

— introduce specific penalties for non-compliance.

Hong Kong (SAR) constituent entities of a group would be required to prepare master and local files for accounting periods beginning on or after 1 April 2018. Reportable groups would be required to file country-by-country reports for accounting periods beginning on or after 1 January 2018.

Dual residency

Based on the tax treaties that Hong Kong (SAR) has concluded to date, a company is generally a resident of Hong Kong (SAR) if it is incorporated in Hong Kong (SAR) or normally managed or controlled in Hong Kong (SAR). Cases of dual residency are resolved either by reference to the company's place of effective management or by mutual agreement.

Foreign investments of a local target company

As explained in this report's section on local holding companies, Hong Kong (SAR) companies are not subject to profits tax on dividends received from overseas companies. Similarly, any profit derived from selling shares in the overseas company is not subject to profits tax where the shares in the overseas company are capital assets of the Hong Kong (SAR) seller, or where the profit is derived from outside Hong Kong (SAR). It is relatively easy for non-financial institutions to make loans of money in a way that ensures any interest income is offshore-sourced.

Hong Kong (SAR) has no controlled foreign company rules.

Comparison of asset and share purchases

Advantages of asset purchases

— Purchase price (or a part of it) may be eligible for outright deduction or capital allowances, depending on the type of asset involved.

— May be possible to step-up the tax basis on depreciable assets.

— Provided certain formalities are complied with, no previous liabilities of the company are inherited.

— No acquisition of a tax liability on retained earnings.

— Possible to acquire only part of a business.

— Greater flexibility in funding options, which can be important because interest incurred to fund the acquisition of shares (which may generate tax-exempt dividends and/ or capital gains/losses) is non-deductible, whereas interest incurred to fund the acquisition of business assets is generally deductible (subject to conditions).

— Profitable operations might be acquired by loss companies in the acquirer's group, thereby effectively gaining the ability to accelerate the use of the losses.

Disadvantages of asset purchases

— Possible recapture of capital allowances claimed.

— Possible need to renegotiate supply, employment and technology agreements.

— Higher capital outlay is usually involved (unless debts of the business are also assumed).

— May be unattractive to the seller, thereby increasing the price.

— Possibly higher transfer duties (depending on the nature of the assets involved).

— Accounting profits may be affected by the creation of purchased goodwill.

— Benefit of any tax losses incurred by the target company remains with the seller (subject to increase or reduction by the amount of any balancing allowances or charges on the sale of any depreciable assets).

— Lower capital outlay (purchase net assets only).

— Likely to be more attractive to the seller, thus reducing the price.

— May benefit from tax losses of the target company (indirectly).

— May gain the benefit of existing supply or technology contracts.

— Lower transfer duties payable on net assets acquired.

— Preserves historical tax attributes, such as tax basis and losses.

Advantages of share purchases

— Lower capital outlay (purchase net assets only).

— Likely to be more attractive to the seller, thus reducing the price.

— May benefit from tax losses of the target company (indirectly).

— May gain the benefit of existing supply or technology contracts.

— Lower transfer duties payable on net assets acquired.

— Preserves historical tax attributes, such as tax basis and losses.

Disadvantages of share purchases

— May acquire unrealized tax liability for depreciation recapture on difference between market and tax book value of assets.

— Liable for any claims or previous liabilities of the entity.

— No depreciation allowances for the purchase price.

— Less flexibility in funding options (i.e. harder to push down acquisition debt to obtain interest deduction without refinancing qualifying, pre-existing intercompany loans).

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India

Introduction

The legal framework for business consolidations in India consists of numerous statutory tax concessions and tax-neutrality for certain kinds of reorganizations and consolidations. This report describes the main provisions for corporate entities. Tax rates cited are for the financial year (FY) ending 31 March 2017, and include a surcharge (12 percent for domestic companies and 5 percent for foreign companies having income over 100 million Indian rupees (INR) (about 1,562,500 US dollars (US$)) and an education cess (tax) of 3 percent.

Recent developments

Finance Bill 2018

Direct tax and Indirect tax changes were introduced in the budget ('Finance Bill') presented on 1 February 2018. The Finance Bill was passed by both Houses of Parliament after some amendments were made. As the next step in the legislative process, the President will need to provide assent before the bill is enacted as a law.

The key tax changes proposed in the Finance Bill affecting mergers and acquisitions (M&A) in India are as follows:

— In FY 2017, the Finance Bill proposes to extend application of the concessionary rate of 25 percent to domestic companies having a turnover of up to INR2.5 billion (about US$39 million) in FY17 (up from turnover of up to INR 500 million (about US$7.7 million) in FY 2016.

— The 3 percent education cess and secondary and higher education cess are replaced by a health and education cess of 4 percent.

— Currently, long-term capital gains (LTCG) arising from the transfer of listed equity shares, or units of an equity-oriented fund (EOF) or business trust held for more than 12 months (sold on a recognized stock exchange) are exempt as long as Securities Transaction Tax (STT) has been paid on such a transaction. The Finance Bill proposes to tax LTCG over INR0.1 million (about US$1,563) (i.e. where the capital asset was held for more than 12 months) arising to all investors including foreign portfolio investors (FPI) from the transfer of listed equity shares or units of an EOF or business trust at the rate of 10 percent (excluding surcharge and cess), provided that STT is paid on such acquisition. To provide relief for historic gains/accretion, when computing capital gains arising on or after 1 April 2018, the cost base for such shares would be their fair market value (FMV) as at 31 January 2018 or the actual cost for the shares, whichever is higher.

General anti-avoidance rule clarification

The general anti-avoidance rule (GAAR) empowers the tax authorities to declare an 'arrangement' entered into by a taxpayer to be an 'impermissible avoidance agreement' (IAA), resulting in denial of the tax benefit under domestic tax laws or a tax treaty. The GAAR provisions took effect as of 1 April 2017 (FY 2018). The India Tax Administration has further issued guidance clarifying the applicability of GAAR provisions under specified scenarios. One of the key clarifications relates to interplay between the limitation on benefit (LOB) article in tax treaties and the GAAR provisions. The guidance clarifies that if the case is sufficiently addressed by the LOB article in the respective tax treaty, GAAR should not be invoked.

Taxability on Indirect share transfers

Where a foreign company transfers shares of a foreign company to another company and the value of the shares is derived substantially from assets situated in India, then capital gains derived on the transfer are subject to income tax in India. Further, payment for such shares is subject to Indian withholding tax (WHT). Shares of a foreign company are deemed to derive their value substantially from assets in India if the value of such Indian assets is at least INR100 million and represents at least 50 percent of the value of all the assets owned by such foreign company.

The India Tax Administration has now notified rules for computing the FMV and consequent gains attributed to assets located in India. The value of assets, both tangible and intangible, is deemed to be their FMV on the 'specified date' without reduction of liabilities (if any) for the asset.

The rules also require the Indian entity and the transferor entities to report the information in prescribed forms.

Limited liability partnerships

The Limited Liability Partnerships Act was passed in 2009, paving the way for setting up limited liability partnerships (LLP) in India. Under this law, a limited liability partnership (LLP) is a corporate entity that exists as a legal person separate from its partners and that is able to enter into binding contracts. LLPs are taxed as normal partnerships; that is, the

profits earned by an LLP are taxed in its hands and shares of profit are exempt in the hands of the partners. Previously, foreign direct investment (FDI) in LLPs was permitted only with government approval and LLPs were not allowed to make downstream investments. The India Exchange Control Regulations have been liberalized to allow foreign companies to be appointed as designated partners (DP) of LLP. Individuals appointed as DP do not need to satisfy the residency test under the Indian Exchange Control Regulations.

Further, conversion of a company into an LLP has been now permitted under an automatic route, subject to the condition that 100 percent FDI is permitted under the automatic route to the company under consideration. Conversion of a company into LLP is exempt from domestic capital gains tax if prescribed conditions are met.

Place of effective management

For foreign companies, the test of residence under the domestic tax laws of India is whether the company is incorporated in India or has its 'place of effective management' in India (POEM). POEM has been defined as "a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance made". The India Tax Administration has further issued guiding principles to be followed for determination of POEM. The guidelines primarily consider whether the company is engaged in 'active business outside India'. The guidelines state that the concept of POEM is one of substance over form.

Valuation of equity shares

Recipient-based taxation of specified property

Under previous tax laws, recipient-based taxation in the hands of a company was restricted to unlisted equity shares and the deemed FMV was based on book value computation. The application of recipient-based taxation in cases of no or inadequate consideration for the receipt of specified property has been widened to include both unlisted and listed securities. Further, taxability on receipt of specified property (e.g. shares, securities, jewelry, immoveable property) for no or inadequate consideration was extended to all taxpayers (including company and firms) as of 1 April 2017.

Further, the rules for valuation of equity shares were amended to compute FMV for tax purposes. The rules require the valuation of equity shares to take into account the FMV of underlying assets, such as the FMV of jewelry, artistic work, shares and securities, guidance value/stamp duty value in case of immovable property, and book value for the other assets.

Deemed FMV on transfer of unlisted shares in the hands of the Transferor

The Indian tax laws were amended as of 1 April 2017 to include deemed FMV in the hands of seller on transfer of unlisted shares at less than FMV. The FMV of shares for tax purposes is computed in the same way as it is for recipient-based tax.

Thin capitalization

India introduced thin capitalization provisions with effect from 1 April 2017. Under these rules, the total interest deduction for Indian companies and permanent establishments (PE) of foreign companies is capped at 30 per cent of earnings before interest, taxes, depreciation and amortization (EBITDA). The rules also apply to debt issued or guaranteed (including implicit guarantee) by a non-resident associated enterprise. The interest disallowed is eligible to be carried forward for 8 years and is deductible in later years, subject to a cap of 30 percent.

Conversion of preference shares into equity shares

Under previous provisions, conversion of a bond or debenture into equity shares was specifically exempt from the capital gains tax. Effective 1 April 2017, capital gains tax exemption has been extended on the conversion of preference shares into equity shares. Further, when equity shares are later sold, the acquisition cost and holding period of the preference shares will be grandfathered.

Dividend income taxable in the hands of resident non-corporates (individuals, firms/LLPs)

Under previous provisions, dividend income was exempt for shareholders provided the company declaring the dividends paid the dividend distribution tax on their distribution. Effective 1 April 2017, India tax laws have introduced an additional tax of 10 percent (excluding surcharge and cess) for resident non-corporates (i.e. individuals, firms, LLPs) on their dividend income exceeding INR1 million. The additional tax does not apply to non-resident shareholders (including foreign companies).

Real estate investment trust update

In 2014, the Securities and Exchange Board of India (SEBI) introduced a new vehicle for investment in the real estate sector, the real estate investment trust (REIT), which invests in completed, rent-yielding real estate properties.

The India Exchange Control Regulations have been amended to permit foreign investment in REITs, including raising debt under external commercial borrowing (ECB) guidelines, subject to certain conditions. Banks are also allowed to participate in REIT in certain conditions.

Goods and services tax

In July 2017, a goods and services tax (GST) was introduced in India. The GST is an umbrella tax that subsumed a number of indirect taxes, such as excise duty, service tax, value added tax (VAT), central sales tax, and entry tax.

Under GST, the type of taxes levied are integrated GST, central GST, state/union GST and GST compensation cess. GST applies primarily at four tax rates (i.e. 5, 12, 18 and 28 percent) depending on the category of goods or service.

Impact of Companies Act, 2013

Companies Act, 1956 has been replaced with Companies Act, 2013 in a phased manner. In December 2016, the India Corporate Law Regulator notified sections under the new Companies Act, 2013 relating to mergers, demergers, arrangements and liquidation. Under these provisions, all mergers and demergers must now approved by the Jurisdictional National Company Law Tribunal Courts (instead of the High Courts under the previous rules). Further, the provisions in relation to inbound merger (merger of a foreign company into an Indian company) and outbound merger (merger of an India company into a foreign company) have also become effective. However, the India Exchange Control Regulations for outbound mergers are yet to be notified.

Securities and Exchange Board of India

The SEBI governs securities that are publicly traded in India. The SEBI has set out additional information rules requiring public shareholders' approval in schemes of arrangements involving listed entities. Approval by SEBI and stock exchanges approval is not required for schemes involving the merger of a wholly owned subsidiary or its division with the parent company. Further, electronic voting is now mandatory for schemes involving listed companies.

Asset purchase or share purchase?

The acquisition of the business of an Indian company can be accomplished by the purchase of shares or the purchase of all or some of the assets. From a tax perspective, long-term capital gains arising on a sale of equity shares through the recognized stock exchanges in India are exempt from tax, provided STT is paid. All other gains on sales of assets are taxable. In some cases (in addition to capital gains taxes), other transfer taxes, such as stamp duty, may also be levied. A detailed comparison of the various types of purchases is provided at the end of this report.

Purchase of assets

A purchase of assets can be achieved through either a purchase of a business on a going-concern basis or a purchase of individual assets. A business could be acquired on either a 'slump-sale' or 'itemized sale' basis. The sale of a business undertaking is on a slump-sale basis when the entire business is transferred as a going concern for a lump-sum consideration — cherry-picking of assets is not possible. An itemized sale occurs either where a business is purchased as a going concern and the consideration is specified for each asset or where only specific assets or liabilities are transferred — cherry-picking of assets by the buyer is an option. The implications of each type of transaction are described later in this report.

Purchase price

The actual cost of the asset is regarded as its cost for tax purposes. This general rule may be subject to some modifications depending on the nature of asset and the transaction. Allocation of the purchase price by the buyer on an acquisition through a slump sale is critical from a tax perspective because the entire business undertaking is transferred as a going concern for a lump-sum consideration. The tax authorities normally accept allocation of the purchase price on a fair value or other reasonable commercial basis. Reports from independent valuations providers are also acceptable.

For itemized sale transactions, the cost paid by the acquirer as agreed upfront may be accepted as the acquisition cost, subject to certain conditions. Therefore, under both slump sales and itemized sales, a step-up in the cost base of the assets may be obtained.

Goodwill

Goodwill arises when the consideration paid is higher than the total fair value/cost of the assets acquired. This arises only in situations of a slump-sale. The tax law only permits depreciation/amortization of intangible assets, such as know-how, patents, copyrights, trademarks, licenses and franchises or any similar business or commercial rights. Therefore, when the excess of consideration over the value of the assets arises because of these intangible assets, a depreciation allowance may be available. Recent judicial precedents have allowed depreciation on goodwill arising out of amalgamation by treating it as a depreciable asset.

Depreciation

Depreciation charged in the accounts is ignored for tax purposes. The tax laws provide for specific depreciation rates for the tangible assets (buildings, machinery, plant or furniture), depending on the nature of asset used in the business. Additional depreciation of 20 percent is available for new plant and machinery used in manufacturing or production provided prescribed conditions are met. An additional 15 percent deduction was recently announced for manufacturing companies, subject to prescribed conditions. Depreciation on eligible intangible assets (described above) is allowed at a flat rate of 25 percent. Certain assets, such as computer software, enjoy higher tax depreciation at 60 percent.

Depreciation is allowed on a 'block of assets' basis. All assets of a similar nature are classified under a single block — and any additions/deletions are made directly in the block. The depreciation rates apply on a reducing-balance basis on the entire block. However, companies engaged in the generation and/or distribution of power have the option to claim depreciation on a straight-line basis. In the first year, if the assets are used in the business for less than 180 days, only half of the entire eligible depreciation for that year is deductible. When the assets are used for more than 180 days in the first year, the entire eligible depreciation for that year is allowed. Capital allowances are available for certain types of asset, such as assets used in scientific research or other specified businesses, subject to certain conditions.

Tax attributes

Tax losses are normally not transferred irrespective of the method of asset acquisition. The seller retains them.

However, certain tax benefits/deductions that are available to an undertaking may be available to the acquirer when the undertaking as a whole is transferred as a going concern as a result of a slump-sale.

Where proceedings are pending against the transferor, the tax authorities have the power to claim any tax on account of completion of the proceeding from the transferee where the transfer is made for inadequate consideration.

Indirect taxes

Typically, no GST implications arise on sale of a business as a whole on a going-concern basis wherein all the assets and liabilities (including movable and immovable property, including stock-in-trade and other goods) are transferred for a lump-sum consideration (i.e. a separate price is not assigned to each asset or liability).

Unlike a slump-sale, in an itemized sale, individual assets are transferred at a specified price for each asset transferred. Accordingly, GST would apply to each asset based on the applicable tax rates (i.e., 5, 12,18 or 28 percent).

Depending on the nature of the item sold, the transferee may be able to recover GST paid by the transferor through input credit.

Transfer taxes

The transfer of assets by way of a slump-sale attracts stamp duty. Stamp duty implications differ from state to state. Rates generally range from 5 to 10 percent for immovable property and from 3 to 5 percent for movable property, usually based on the amount of consideration received for the transfer or the market value of the property transferred (whichever is higher). Depending on the nature of the assets transferred, appropriate structuring of the transfer mechanism may reduce the overall stamp duty cost.

Purchase of shares

Businesses can be acquired through a purchase of shares. No step-up in the cost of the underlying business is possible in a share purchase, in the absence of a specific provision in the tax law. No deduction is allowed for a difference between the underlying net asset values and the consideration paid (see 'Concerns of the seller').

Tax indemnities and warranties

In a share acquisition, the purchaser takes over the target company together with all its related liabilities, including contingent liabilities. Hence, the purchaser normally requires more extensive indemnities and warranties than in the case of an asset acquisition.

An alternative approach is for the seller's business to be transferred into a newly formed entity, so the purchaser can take on a 'clean' business and leave its liabilities behind. Such a transfer may have tax implications. When significant sums are involved, it is customary for the purchaser to initiate a due diligence exercise. Normally, this would incorporate a review of the target's tax affairs.

Tax losses

Tax losses consist of normal business losses and unabsorbed depreciation (where there is insufficient income to absorb the current-year depreciation). Both types of losses are eligible for carry forward and available for the purchaser. Business tax losses can be carried forward for a period of 8 years and offset against future profits. Unabsorbed depreciation can be carried forward indefinitely.

However, one essential condition for setting off business losses is the shareholding continuity test. Under this test, the beneficial ownership of shares carrying at least 51 percent of the voting power must be the same at the end of both the year during which the loss was incurred and the year during which the loss is proposed to be offset.

In order to promote business start-ups in India, the Finance Act 2017 amended these rules to allow eligible start-up companies to carry forward their first 7 years of losses as long as all the shareholders carrying voting power on the last day of year of loss continue to hold those shares on the last day of the year of change in shareholding. This test only applies to business losses (not unabsorbed depreciation) and to unlisted companies (commonly called 'closely held companies').

Transfer taxes

STT may be payable if the sale of shares is through a recognized stock exchange in India. STT is imposed on purchases and sales of equity shares listed on a recognized stock exchange in India at 0.1 percent based on the purchase or sale price. STT is payable both by the buyer and the seller on the turnover (which is a product of number of shares bought/sold and price per share).

Transfers of shares (other than those in de-materialized form, which are normally traded outside the stock exchanges) are subject to stamp duty at the rate of 0.25 percent of the market value of the shares transferred.

Tax clearances

In the case of a pending proceeding against the transferor, the tax authorities have the power to claim any tax on account of completion of the proceeding from the transferee where the transfer is made for inadequate consideration. Income tax law provides mechanism for obtaining a tax clearance certificate for transfer of assets/business subject to certain conditions.

Choice of acquisition vehicle

Several possible acquisition vehicles are available in India to a foreign purchaser. Tax and regulatory factors often influence the choice of vehicle.

Local holding company

Acquisitions through an Indian holding company are governed by the downstream investment guidelines issued in 2009 under FDI policy. Broadly, any indirect foreign investments (through Indian companies) are not construed as foreign investments where the intermediate Indian holding company is owned and/or controlled by resident Indians. The criteria for determining the ownership and control of an Indian company are ownership of more than 50 percent of the shares along with control of the governing board. Downstream investments made by Indian entities are not considered in determining whether these criteria are met.

Dividends in India are subject to a dividend distribution tax (DDT) of 15 percent excluding surcharge and cess (effective rate of 20.358 percent after applying grossing-up provisions). A parent company may be able to obtain credit for the DDT paid by its subsidiaries against its DDT liability on dividends declared.

Foreign parent company

Foreign investors may invest directly through a foreign parent company, subject to the prescribed foreign investment guidelines.

Non-resident intermediate holding company

An intermediate holding company resident in another territory could be used for investment into India, to minimize the tax leakage in India through, for example, source withholdings and capital gains taxes on exit. This may allow the purchaser to take advantage of a more favorable tax treaty with India. However, evidence of substance in the intermediate holding company's jurisdiction is required. LOB conditions are applicable where the tax treaty has an LOB clause (e.g. Mauritius, Singapore).

WHT on sale by non-resident

WHT applies at the applicable rates to any payment made to a non-resident seller for the purchase of any capital asset on account of any capital gains that accrue to the seller. Applicable tax treaty provisions also need to be evaluated in order to determine the withholding tax rates.

Local branch

The Reserve Bank of India (RBI) regulates the establishment of branches in India. The prescribed guidelines do not permit a foreign company to use the branch as a vehicle for acquiring Indian assets.

Joint venture

Joint ventures are normally used where specific sectoral caps are applicable under the foreign investment guidelines. In such scenarios, a joint venture with an Indian partner is set up that will later acquire the Indian target. In planning a joint venture, the current guidelines for calculating indirect foreign investments should be considered.

Choice of acquisition funding

A purchaser using an Indian acquisition vehicle to carry out an acquisition for cash needs to decide whether to fund the vehicle with debt, equity or a hybrid instrument that combines the characteristics of both. The principles underlying these approaches are discussed below.

Debt

Tax-deductibility of interest makes debt funding an attractive method of funding. Debt borrowed in foreign currency is governed by the RBI's external commercial borrowing (ECB) guidelines, which impose restrictions on ECB in terms of the amount, term, cost, end use and remittance into India. The guidelines prohibit an eligible borrower of ECBs to use the proceeds for certain purposes, including to fund any acquisition of shares.

Borrowing funds from an Indian financial institution is worth considering as interest on such loans can be deducted from the operating profits of the business to arrive at the taxable profit. This option is likely to have the following advantages:

— no regulatory approvals required

— flexibility in repayment of funds

— no ceiling on rate of interest

— no hedging arrangements required

— no WHT on interest.

However, bank loans may have end-use restrictions.

The ECB Regulations notified by the India Exchange Regulator outline various conditions for foreign currency debt classified as ECB. This specifically includes definitions of (among others) 'eligible borrower', 'recognized lender', forms of ECB, end-use restrictions and all-in-cost ceilings.

Further, the SEBI Regulations permit issue of listed non-convertible debentures (NCD) as another instrument for public debt fund raising subject to provisions specified under Listing Regulations. As these instruments are not within the ECB framework, there are fewer restrictions (e.g. no sectoral caps, investment limits or end-use restrictions as in case of ECB). Unlisted NCDs continue to be governed by the ECB Regulations.

Deductibility of interest

Normally, the interest accounted for in the company's books of accounts is allowed for tax purposes. Interest on loans from financial institutions and banks is normally only allowed when actually paid. Other interest (to residents and non-residents) is normally deductible from business profits, provided appropriate taxes have been withheld thereon and paid to the government treasury. In any case, interest expenditure for acquiring Indian company shares is not tax-deductible.

India has introduced thin capitalization provisions with effect from 1 April 2017. Under these provisions, the total interest deduction for Indian companies and PEs of foreign companies is capped at 30 per cent of EBITDA. Debt issued or guaranteed (including implicit guarantee) by non-resident AEs are also covered. The interest disallowed can be carried forward for 8 years and is deductible in a subsequent year, subject to a cap of 30 percent.

Further, under GAAR provisions (applicable from 1 April 2017), if an arrangement is declared to be an 'impermissible avoidance agreement' (IAA), then any equity may be treated as debt and vice versa.

Withholding tax on debt and methods to reduce or eliminate it

Interest paid by Indian company to a non-resident is normally subject to WHT of 21.63 percent. The rate may be reduced under a tax treaty, subject to its conditions.

Specified foreign investors (i.e. foreign institutional investors (FII) and qualified foreign investors (QFI)) are subject to 5.5105 percent WHT on an INR-denominated bond of an Indian company or a government security on which interest is payable after 1 June 2013 and before 1 July 2020. Similarly, the lower WHT of 5.5105 percent on interest paid on ECBs to non-residents is extended to INF-denominated bonds as of 1 April 2016 and the borrowings period is extended to 1 July 2020.

Checklist for debt funding

— Foreign currency-denominated debt must conform to ECB guidelines.

— Consider the WHT on the interest expenses for domestic and foreign debt.

— Assess whether the profits in the Indian target entity are sufficient to make the interest deduction effective.

— Estimate EBIDTA to assess interest deductibility under the thin capitalization rules.

— All external borrowings (foreign debt) from associated enterprises should comply with the transfer pricing rules.

Equity

Most sectors in India have been opened up for foreign investment, so no approvals from the government of India should be necessary for the issue of new shares in these sectors. Certain sectors are subject to restrictions or prohibitions on foreign investment that require the foreign investor to apply to the government of India for a specific approval. Pricing of the shares must comply with guidelines issued by the RBI.

Dividends can be freely repatriated under the current exchange control regulations. Dividends can be declared only out of profits (current and accumulated), subject to certain conditions.

Under the provisions of Indian tax laws, no WHT applies at the time of the distribution of dividends to the shareholders. However, the domestic company must pay dividend distribution tax (DDT) at the rate of 15 percent excluding surcharge and cess (for an effective tax rate of 20.358 percent after applying grossing-up provisions) on the amount of dividends actually paid to the shareholders. Dividends are not tax-deductible. However, an Indian parent company can take credit for DDT paid by its subsidiary, subject to certain conditions.

Further, dividends paid by domestic companies are exempt for non-resident shareholders if the India company declaring dividend has paid DDT on the dividends distributed. As noted earlier, as of 1 April 2017, India has introduced an additional tax of 10 percent (excluding surcharge and cess) for resident non-corporates (i.e. individuals, firms, LLPs) on dividend income exceeding INR1 million. The additional tax does not apply to non-resident shareholders (including foreign companies).

For outbound investments, gross dividends received by an Indian company from a specified foreign company (in which it has shareholding of 26 percent or more) are taxable at a concessional rate of 17.304 percent, subject to certain conditions. Further, credit of such dividends is received against dividends paid by the Indian company for DDT purposes. This treatment aims to encourage the repatriation of income earned by residents from their foreign investments.

Under current company law, equity capital cannot be withdrawn during the lifespan of the company, except through a buy-back of shares. Ten percent of the capital can be bought back with the approval from the board of directors, and up to 25 percent can be bought back with approval of shareholders, subject to other prescribed conditions.

India tax laws levy buy-back tax at the rate of 23.072 percent on the buy-back of shares by an unlisted company to the extent of the amount distributed over the amount received by the company from the shareholders on issuing the shares. The tax is payable by the Indian unlisted company, and buyback proceeds are exempt for the shareholder.

Business reorganization

Merger/amalgamation

In India, mergers (amalgamations) are infrequently used for acquisition of business, but they are used extensively to achieve a tax-neutral consolidation of legal entities in the course of corporate reorganizations. Amalgamations enjoy favorable treatment under income tax and other laws, subject to certain conditions. The important provisions under Indian laws relating to amalgamation are discussed below.

Tax neutrality

Indian tax law defines 'amalgamation' as a merger of one or more companies into another company or a merger of two or more companies to form a new company such that:

— all the properties and liabilities of the merging companies immediately before the amalgamation become the properties and liabilities of the amalgamated company

— shareholders holding at least three-quarters of the shares in the amalgamating companies become shareholders of the amalgamated company (any shares already held by the amalgamated company or its nominees are excluded for purposes of this calculation).

From 1 April 2005, the transfer of a capital asset by a banking company to a banking institution in the course of amalgamating the two banking entities as directed and approved by the RBI is not regarded as a transfer for capital gains purposes. The cost of acquiring the capital asset is deemed to be the cost at which the amalgamating banking company acquired it.

Generally, the transfer of any capital asset is subject to capital gains tax in India. However, amalgamation enjoys tax-neutrality with respect to transfer taxes under Indian tax law — both the amalgamating company transferring the assets and the shareholders transferring their shares in the amalgamating company are exempt from tax. To achieve tax-neutrality for the amalgamating company (or companies) transferring the assets, the amalgamated company should be an Indian company. In addition, to achieve tax-neutrality for the shareholders of the amalgamating company, the entire consideration should comprise shares in the amalgamated company.

Further, India tax laws provide for exemption from capital gains arising pursuant to indirect transfer of shares resulting from a merger or demerger of two foreign companies.

Carry forward and offset of accumulated losses and unabsorbed depreciation

Unabsorbed business losses, including depreciation of capital assets, of the amalgamating company (or companies) are deemed to be those of the amalgamated company in the year of amalgamation. In effect, the business losses get a new lease of life as they may be carried forward for up to 8 years.

However, the carry forward is available only where:

— the amalgamating company owns a ship or hotel or is an industrial undertaking (manufacturing or processing of goods, manufacturing of computer software, electricity generation and distribution, telecommunications, mining or construction of ships, aircraft or rail systems)

— the amalgamating companies are banking companies.

The carry forward of losses on amalgamation is subject to additional conditions under the income tax law.

Other implications

Other implications of amalgamation include the following.

— Where a business unit/undertaking develops/operates an infrastructure facility, telecommunication service, or is in the business of power generation, transmission or distribution, and the business unit/undertaking is merged, then the tax benefits it enjoys cannot be claimed by the amalgamated company, where specifically restricted under the tax law. Various tax incentives still may be available as long no specific restriction applies under the law.

— The basis for claiming tax depreciation on assets of amalgamating company (or companies) acquired on amalgamation remains the same for the amalgamated company. No step-up in the value of assets acquired on amalgamation is possible for tax purposes.

— The total depreciation on assets transferred to the amalgamated company in that financial year is apportioned between the amalgamating and amalgamated company in the ratio of the number of days for which the assets were used by each entity during the year. Thus, depreciation up to the effective date of transfer is available to the amalgamating company and depreciation after that date is available to the amalgamated company.

— Amalgamation expenses can be amortized in five equal annual installments, starting in the year of amalgamation.

— Unamortized installments of certain deductions eligible to the amalgamating company (or companies) are allowable for the amalgamated company.

Corporate law

Corporate reorganizations involving amalgamations of two or more companies require the approval of the National Company Law Tribunal under the amended Companies Act, 2013. As noted, the provisions for inbound and outbound mergers have become effective but the India Exchange Control Regulations for outbound mergers are not yet notified (see 'Impact of Companies Act, 2013').

Further, provisions for mergers of specified small companies and of holding/parent companies with wholly owned subsidiary companies can be undertaken without court approval (commonly called 'fast-track mergers'). Such mergers must be approved by the Jurisdictional Corporate Law Regulator, which typically takes 3 to 4 months.

Transfer taxes

The transfer of assets, particularly immovable properties, requires registration with the state authorities for purposes of authenticating transfer of title. Such registration requires payment of stamp duty. Stamp duty implications differ from state to state. Generally, rates of stamp duty range from 5 to 10 percent for immovable properties and from 3 to 5 percent for movable properties, usually calculated on the amount of consideration received for the transfer or the market value of the property transferred (whichever is higher). Some state stamp duty laws contain special beneficial provisions for stamp duty on court-approved mergers.

Typically, no GST implications may arise on sale of a business as a whole on a going concern basis wherein all the assets and liabilities (including movable and immovable property,

including stock-in-trade and other goods) are transferred under mergers/demergers.

Exchange control regulations

In India, capital account transactions are still not fully liberalized. Certain foreign investments require the approval of the government of India. A court-approved merger is specifically exempt from obtaining any such approvals where, post-merger, the stake of the foreign company does not exceed the prescribed sectoral cap. However, the India Exchange Control Regulations for outbound mergers are yet to be notified.

Takeover code regulations

The acquisition of shares in a listed company beyond a specific percentage triggers implications under the Takeover Code Regulations of SEBI. However, a court-approved merger directly involving the target company is specifically excluded from these regulations. A court-approved merger that indirectly involves the target is also excluded where prescribed conditions are met.

Therefore, a court-approved merger is the most tax-efficient means of corporate consolidation or acquisition, apart from these disadvantages:

— more procedural formalities and a longer timeframe of 6 to 8 months

— both parties must be corporate entities and the transferee company must be an Indian company.

Competition Commission of India regulations

Any merger or amalgamation is regarded as a combination if it meets certain threshold requirements; if so, approval from the Competition Commission of India is required. Exemptions are available for an amalgamation of group companies in which more than 50 percent of the shares are held by enterprises within the same group.

General anti-avoidance rule

The GAAR provisions apply only if the tax benefit arising to all parties to an arrangement exceeds INR30 million in the relevant financial year. The GAAR empowers the tax authorities to declare an 'arrangement' entered into by a taxpayer to be an IAA, resulting in denial of tax benefits. An IAA is an arrangement the main purpose of which is to obtain a tax benefit and that results in the misuse of tax provisions, lacks commercial substance, is not for a bona fide purpose, or creates rights and obligations not created while dealing at arm's length.

The GAAR does not apply to arrangements where the court has explicitly and adequately considered the tax implications while sanctioning an arrangement. Also, any ruling by the Authority for Advance Ruling, the Principal Commissioner of Income-tax, Commissioner of Income-tax or the Income-tax authorities is binding in nature and results in non-applicability of GAAR.

Demerger

The separation of two or more existing business undertakings operated by a single corporate entity can be achieved in a tax-neutral manner under a 'demerger'. The key provisions under Indian law relating to demerger are discussed below.

Income tax law

Indian tax law defines 'demerger' as the transfer of one or more undertakings to any resulting company, pursuant to a court-approved scheme of demerger such that as a result of the demerger:

— All the property and liabilities relating to the undertaking being transferred by the demerger company immediately before the demerger become the property and liabilities of the resulting company.

— Such property and liabilities are transferred at values appearing in the books of account of the demerged company (for determining the value of the property, any revaluation is ignored).

— In consideration of a demerger, the resultant company issues its shares to the shareholders of the demerged company on a pro rata basis.

— Shareholders holding three-quarters of the shares in the demerged company become shareholders of the resultant company (any shares already held by the resultant company or its nominees are excluded for the purposes of this calculation).

— The transfer of the undertaking is on a going-concern basis.

'Undertaking' is defined to include any part of an undertaking or a unit or division of an undertaking or a business activity taken as a whole. It does not include individual assets or liabilities or any combination thereof not constituting a business activity.

In a demerger, the shareholders of the demerged company receive shares in the resultant company. The cost of acquisition of the original shares in the demerged company is split between the shares in the resultant company and the demerged company in the same proportion as the net book value of the assets transferred in a demerger bears to the net worth of the demerged company before demerger. ('Net worth' refers to the aggregate of the paid-up share capital and general reserves appearing in the books of account of the demerged company immediately before the demerger.)

Generally, the transfer of any capital asset is subject to transfer tax (capital gains tax) in India. However, a demerger enjoys a dual tax-neutrality with respect to transfer taxes under Indian tax law: both the demerged company transferring the undertaking and the shareholders transferring their part of the value of shares in the demerged company are tax-exempt. To achieve tax-neutrality for the demerged company transferring the undertaking, the resultant company should be an Indian company.

Other provisions of the income tax law are as follows:

— The unabsorbed business losses, including depreciation (i.e. amortization of capital assets) of the demerged company directly related to the undertaking transferred to the resultant company are treated as unabsorbed business losses or depreciation of the resultant company. If such losses, including depreciation, are not directly related to the undertaking being transferred, the losses should be apportioned between the demerged company and the resulting company in the proportion in which the assets of the undertaking have been retained by the demerged company and transferred to the resulting company.

— The unabsorbed business losses of the demerged company may be carried forward and set off in the resultant company for that part of the total permissible period that has not yet expired by the resultant company and the demerged company in the same proportion in which assets have been transferred and retained pursuant to demerger.

— Where a business unit/undertaking that develops/operates an infrastructure facility or telecommunication service, or is in the business of power generation, transmission or distribution, etc., is demerged, then the tax benefits it enjoys cannot be claimed by the resultant company where the income tax law specifically disallows such a claim.

— If any undertaking of the demerged company enjoys any tax incentive, the resulting company generally can claim the incentive for the unexpired period, even after the demerger.

— The total depreciation on assets transferred to the resulting company in a financial year is apportioned between the demerged company and the resulting company based on the ratio of the number of days for which the assets were used by each during the year. Depreciation up to the effective date of transfer is available to the demerged company and thereafter to the resulting company.

— The expenses of a demerger can be amortized in five equal annual installments, starting in the year of the demerger.

— A step-up in the value of the assets is not permissible either in the books or for tax purposes.

Any corporate reorganization involving the demerger of one or more undertakings of a company now requires the approval of the jurisdictional courts of the National Company Law Tribunal. Obtaining the approval normally takes 6 to 8 months.

The transfer of assets, particularly immovable property, requires registration with the state authorities to authenticate transfers of title. Such registration requires payment of stamp duty, which differs from state to state. The rates range from 5 to 10 percent for immovable property and from 3 to 5 percent for movable property. Rates are generally calculated based on the consideration received or the market value of the property transferred, whichever is higher. Some state stamp duty laws contain special stamp duty privilege for court-approved demergers.

Typically, there are no GST implications of a court-approved demerger on a going concern basis.

Exchange control regulations

A court-approved demerger is specifically exempt from obtaining government approval where, following the demerger, the investment of the foreign company does not exceed the sectoral cap.

A court-approved demerger is the most tax-efficient way to effect a divisive reorganization, apart from these disadvantages:

— more procedural formalities and longer time frame of 6 to 8 months

— for tax neutrality, consideration must be the issue of shares of resultant company to shareholders of demerged company.

Hybrids

Preference capital is used in some transaction structuring models. Preference capital has preference over equity shares for dividends and repayment of capital, although it does not carry voting rights. An Indian company cannot issue perpetual (non-redeemable) preference shares. The maximum redemption period for preference shares is 20 years. Preference dividends can be only declared out of profits. Dividends on preference shares are not a tax-deductible cost. Preference dividends on fully convertible preference shares can be freely repatriated under the current exchange control regulations. The maximum rate of dividend (coupon) that can be paid on such preference shares should be in accordance with the norms prescribed by the Ministry of Finance (generally, 300 basis points above the prevailing prime lending rate of the State Bank of India).

The redemption/conversion (into equity) feature of preference shares makes them attractive instruments. Preference capital can only be redeemed out of the profits of the company or the proceeds of a new issue of shares made for the purpose. The preference shares may be converted into equity shares, subject to the terms of the issue of the preference shares. On the regulatory front, a foreign investment made through fully compulsorily convertible preference shares is treated the same as equity share capital. Accordingly, all regulatory norms applicable for equity apply to such securities. Other types of preference shares (non-convertible, optionally convertible or partially convertible) are considered as debt and must be issued in conformity with the ECB guidelines discussed above in all aspects. Because of the ECB restrictions, such non-convertible and optionally convertible instruments are not often used for funding acquisitions.

Call/put options

Until recently, options (call/put) in investment agreements contravened Indian securities law. However, SEBI now permits contracts consisting of pre-emption rights, such as options, right of first refusal, and tag-along/drag-along rights in shareholder or incorporation agreements.

Further, to align this amendment, the RBI has notified that the use of options is subject to certain pricing guidelines that principally do not provide the investor an assured exit price and conditions as to the lock-in period. FDI regulations also permit issue of non-convertible/redeemable bonus preference shares or debentures (bonus instrument) to non-resident shareholders under the automatic route.

Another possibility is the issuance of convertible debt instruments. Interest on convertible debentures normally is allowed as a deduction for tax purposes. However, like preference shares, all compulsorily convertible debentures are treated the same as equity. Other non-convertible, optionally convertible or partly convertible debentures must comply with ECB guidelines.

Other considerations

Concerns of the seller

Asset purchase

Both slump sales and itemized sales are subject to capital gains tax in the hands of the sellers. For slump sales, consideration exceeding the net worth of the business is taxed as capital gains. Net worth is calculated under the provisions of the Income Tax Act, 1961. Where the business of the transferor company is held for more than 36 months (24 months for immovable property), such an undertaking is treated as a long-term capital asset and the gains from its transfer are taxed at a rate of 23.072 percent for a domestic company. Otherwise, these gains are taxed at 34.61 percent.

Capital gains taxes arising on an itemized sale depend on the nature of assets, which can be divided into three categories:

— tangible capital assets

— stock-in-trade

— intangibles (e.g. goodwill, brand).

The tax implications of a transfer of capital assets (including net current assets other than stock-in-trade) depend on whether the assets are eligible for depreciation under the India tax laws.

For assets on which no depreciation is allowed, consideration in excess of the cost of acquisition and improvement is taxable as a capital gain. If the assets of the business are held for more than 36 months (24 months for immovable property), the assets are classified as long-term capital assets. For listed securities or units of equity-oriented funds or zero coupon bonds, the eligible period for classifying them as long-term assets is 12 months.

The gains arising from transfers of long-term capital assets are taxed at a 23.072 percent rate for a domestic company and 21.63 percent for a foreign company. When calculating the inflation adjustment, the asset's acquisition cost can be the original purchase cost. Inflation adjustment is calculated on the basis of inflation indices prescribed by the government of India. (Where the capital asset was acquired on or before 1 April 2001, the taxpayer has the option to use the asset's FMV as of 1 April 2001 for this calculation).

Where the assets of the business are held for not more than 36 months (12 months for listed securities, units of equity-oriented funds and zero coupon bonds and 24 months for immovable property), capital gains on the sale of such short-term capital assets are taxable at the rates of 34.61 percent for a domestic company and 43.26 percent for a foreign company.

For assets on which depreciation has been allowed, the consideration is deducted from the tax written-down value of the block of assets (explained below), resulting in a lower claim for tax depreciation going forward.

If the unamortized amount of the block of assets is less than the consideration received or the block of assets ceases to exist (i.e. there are no assets in the category), the difference is treated as a short-term capital gain and subject to tax at 34.61 percent for a domestic company and at 43.26 percent for a foreign company. If all the assets in a block of assets are transferred and the consideration is less than the unamortized amount of the block of assets, the difference is treated as a short-term capital loss and could be 43.26 offset against capital gains arising in up to 8 succeeding years.

Any gains or losses on the transfer of stock-in-trade are treated as business income or loss. The business income is subject to tax at 34.61 percent for a domestic company and 43.26 percent for a foreign company. Business losses can be offset against income under any category of income arising in that year. If the current year's income is inadequate, business losses can be carried forward to offset against business profits for 8 succeeding years.

The tax treatment for intangible capital assets is identical to that of tangible capital assets, as discussed earlier. India's Supreme Court has held that goodwill arising on amalgamation amounts to an intangible asset that is eligible for depreciation. However, the issue of claiming depreciation on goodwill acquired has been a matter of litigation based on the facts of each case.

Share purchase

The sale of shares is taxed as capital gains for the seller. Further, for the purpose of computing the capital gains tax, where the consideration is less than the FMV of the unlisted shares as computed under the tax laws, the FMV is deemed to be the consideration.

When the shares are held for not more than 24 months (12 months for listed securities, units of equity-oriented funds and zero coupon bonds and 24 months for immovable

property), the gains are characterized as short-term capital gains and subject to tax at the following rates.

If the transaction is not subject to STT:

— 34.61 percent for a domestic company

— 43.26 percent for a foreign company

— 32.445 percent (flat rate) for an FII.

If the transaction is subject to STT, short-term capital gains arising on transfers of equity shares are taxed at the following rates:

— 17.304 percent for a domestic company

— 16.23 percent for a foreign company or FII.

Where the shares have been held for more than 24 months (12 months for listed securities, units of equity-oriented funds and zero coupon bonds and 24 months for immovable property), the gains are characterized as long-term capital gains and subject to tax as follows:

If the transaction is not subject to STT:

— The gains are subject to tax at a 23.072 percent rate for a domestic company and 21.63 percent for a foreign company. Resident investors are entitled to an inflation adjustment when calculating long-term capital gains based on the inflation indices prescribed by the government of India. Non-resident investors are entitled to benefit from currency fluctuation adjustments when calculating long-term capital gains on a sale of shares of an Indian company purchased in foreign currency.

— Income tax on long-term capital gains arising from the transfer of listed securities (from the stock market), which otherwise are taxable at 23.072 percent or 21.63 percent, is restricted to a concessionary rate of 11.54 percent rate for a domestic company. The concessionary rate must be applied to capital gains without applying the inflation adjustment.

— A concessionary rate of 10.82 percent applies on the transfer of capital assets being unlisted securities in the hands of non-residents (including foreign companies). The concessionary rate must be applied to capital gains without the benefit of exchange fluctuation and indexation.

Under the previous provisions, if the transaction was subject to STT on sale, long-term capital gains arising on transfers of equity shares were exempt from tax. In order to curb avoidance, the exemption for long-term capital gains has been restricted to only those listed equity shares for which STT was paid at the time of acquisition. However, to protect genuine cases where the STT could not have been paid on acquisition, the India tax Administration has issued a list of all transactions eligible for the exemption for long-term capital gains.

Company law and accounting

The new Companies Act, 2013, governs companies in India, except for certain provisions that are yet to be notified and continue to be governed under the old Companies Act, 1956.

Corporate restructuring in India continues to be governed under the Companies Act, 1956, which incorporates the detailed regulations for corporate restructuring, including corporate amalgamation or demerger. The National Company Law Tribunal must approve all such schemes. The provisions allowing corporate amalgamations or restructuring provide a lot of flexibility. Detailed guidelines are prescribed for other forms of restructuring, such as capital reduction and buy-back.

Accounting norms for companies are governed by the Accounting Standards issued under the Companies Act. Normally, for amalgamations, demergers and restructurings, the Accounting Standards specify the accounting treatment to be adopted for the transaction.

The accounting treatments are broadly aligned with the provisions of the accounting standard covering accounting for amalgamations and acquisitions. The standard prescribes two methods of accounting: merger accounting and acquisition accounting. In merger accounting, all the assets and liabilities of the transferor are consolidated at their existing book values. Under acquisition accounting, the consideration is allocated among the assets and liabilities acquired (on a fair value basis). Therefore, acquisition accounting may give rise to goodwill, which is normally amortized over 5 years.

The government of India has recently notified International Financial Reporting Standards (IFRS)-converged Indian Accounting Standards (Ind AS). Under the new Ind AS on amalgamation, all assets and liabilities of the transferor are recorded at their respective fair values. Further, goodwill arising on merger is not amortized; instead it is tested for impairment. The accounting treatment of mergers within a group are separately dealt with under the new Ind AS, which requires all assets and liabilities of the transferor to be recognized at their existing book values only.

The new Ind AS are to be implemented in a phased manner. It became applicable to all listed companies and companies with net worth of INR5 billion or more from 1 April 2016, and to companies with net worth of INR2.5 billion crores or more from 1 April 2017. Other companies will continue to apply existing accounting standards.

Transfer pricing

After an acquisition, all intercompany transactions, including interest on loans, are subject to transfer pricing regulations.

Outbound investments

Foreign investments by a local company

Foreign Investments by an Indian company are regulated by the guidelines issued by the RBI. Broadly, an Indian entity can invest up to 400 percent of its net worth (as per audited accounts) in joint ventures or wholly owned subsidiaries overseas, although investments exceeding US$5 million may be subject to certain pricing guidelines. Currently, there are no controlled foreign companies (CFC) regulations in India.

Comparison of asset and share purchases

Advantages of asset purchases

— Faster execution process, because no court approval is required (court approval is required for an acquisition of a business through a demerger).

— Assets and liabilities can be selectively acquired and assumed.

— Possible to restate the values of the assets by the acquirer for accounting and tax purposes, subject to appropriate valuation in a slump-sale and subject to carrying out the transaction at a specified price in an itemized sale of assets.

— Possible to capture the value of brand(s) and intangibles and claim depreciation thereon, subject to appropriate valuation in a slump-sale and subject to carrying out the transaction at a specified price in an itemized sale of assets.

— No requirement to make an open offer, unlike in a share acquisition.

Disadvantages of asset purchases

— The transaction may not be tax-neutral, unlike amalgamations and demergers, among others.

— Approvals may be required from the financial institutions (among others) to transfer assets or undertakings, which may delay the process.

— Continuity of incentives, concessions and unabsorbed losses under direct or indirect tax laws or the Export and Import Policy of India must be considered.

— Stamp duty may be higher.

GST implications need to be considered in an itemized sale of assets. GST is applicable on the movable assets transferred.

Advantages of share purchases

— Faster execution process, because no court approval is required (except where the open offer code is triggered or government approval is required).

— Typically, STT is levied on a sale of equity shares through a recognized stock exchange in India at the rate of 0.1 percent for each such purchase and sale.

— Gains arising on the sale of assets subject to STT held for more than 12 months are exempt from tax, provided STT has been paid.

— On a sale of shares (other than listed securities) held for more than 24 months, a rate of tax of 23.072 percent applies for a domestic company after considering a cost inflation adjustment for gains on transfer of such shares and a concessionary rate of 10.82 percent applies for non-residents (including foreign companies) without benefit of exchange fluctuation and indexation.

— GST may not apply.

Disadvantages of share purchases

— The transaction may not be tax-neutral, and capital gains taxes may arise for the sellers.

— Stamp duty cost at 0.25 percent of total consideration payable on shares held in physical form.

— Not possible to capture the value of intangibles.

— Not possible to step-up the value of assets acquired.

— Consideration paid for acquisition of shares is locked-in until the shares are sold, and embedded goodwill cannot be amortized.

— May require regulatory approval from the government and from regulators such as SEBI.

— Valuation of shares may be subject to the pricing guidelines of the RBI.

— On an acquisition of shares of listed companies, acquiring more than 25 percent would trigger the SEBI Takeover Code, which obliges the acquirer to acquire at least 26 percent of the shares from the open market at a price determined under a prescribed SEBI formula. This may substantially increase the transaction cost and the time needed to complete the transaction because the shares would only vest in the acquirer after the open offer is complete.

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Indonesia

Introduction

As the most populous country and largest economy in Southeast Asia, Indonesia has long been attractive to investors. Recent tax legislation changes and the expansion of incentives should further stimulate investment.

However, some investment restrictions, and some sectors are closed to foreign investors. These are published in the negative investment list, which was most recently updated in May 2016. The list designates various restrictions and prohibitions for certain business sectors, such as sectors where small and medium-sized businesses are protected from larger competitors. The Indonesian government is still discussing which sectors should be opened or closed to foreign investment.

Previously, Indonesian investment law allowed foreign companies and individuals to invest only in certain business sectors by establishing joint venture companies with local partners. The foreign investor could set up a wholly owned company but was required to transfer some of its shares to a local partner within 15 years from the commencement of commercial operations. In many sectors, this restriction has been relaxed to allow foreign investment in a wholly owned company, with no requirement to sell shares to a local partner subsequently.

Applications for foreign investment require approval from the Investment Coordinating Board (BKPM), which evaluates investment applications to determine the adequacy of the proposed investment based on the project's economic feasibility. Foreign companies and foreign individuals may also acquire shares in an existing local company, provided its line of business is open to foreign investment.

Under Indonesian generally accepted accounting principles (GAAP), most combinations are accounted for as acquisitions. Merger accounting is applied in only limited circumstances. Merger accounting is not allowed under International Financial Reporting Standards (IFRS); all business combinations must be treated as acquisitions. However, Indonesian GAAP currently allows the use of the uniting-of-interests method in certain rare circumstances. Indonesia has adopted IFRS but currently follows the 2007 version. The more recent IFRS will be implemented in Indonesia at a later date.

Recent developments

The following summary of Indonesian tax developments is based on current tax legislation and guidance.

In 2008, regulations and related guidance were introduced to help the Indonesian Tax Office (ITO) combat what it perceived to be a number of mergers motivated solely to obtain tax advantages. The provisions primarily aim to restrict tax relief and tighten documentation requirements for the transfer of assets in a merger, consolidation or expansion.

The regulations impose more conditions on tax-neutral transfers of assets. The seller and the acquiring company must pass a business purpose test to ensure the motivation of the merger or expansion is to create strong business links or bolster the capital structure, rather than to avoid tax. Where the transfer occurs within the context of a business expansion (separation of a company into two or more entities), the new regulations only allow the transfer of assets to be recorded at book value if the transferor and/or buyer are planning an initial public offering (IPO). If an application for an IPO is not submitted to the stock exchange within 1 year of the transfer, the relief may be clawed back.

A notable absence from the new regulations is the entitlement of a taxpayer to transfer losses. Previously, tax relief for pre-acquisition losses could be transferred to the buyer under certain conditions. Under the current regulations, losses remain with the entity incurring them. If the acquired entity ceases to exist or becomes dormant following a business acquisition, the tax losses within that entity become unavailable for relief against any future profits. Further, the surviving entity is required to be either loss-free or the entity with the lowest losses among the merging entities.

Where an application to transfer assets at book value receives the required approval from the Director General of Taxation (DGT), the acquiring company should assume the asset history of the transferor (i.e. the remaining useful life and depreciation method should be recorded and applied by the acquiring company). Such an application is required within 6 months of the date of transfer. Approval is only granted where both transferor and transferee have no outstanding tax assessments or unpaid tax balances. The DGT is required to respond within 1 month of the application. A number of other conditions must be satisfied. If they are not met, the transfer of assets is assessed at market value. It is, therefore, strongly recommended to seek advice when planning an acquisition to ensure the transaction qualifies for relief.

Indonesia's amended value added tax (VAT) legislation took effect as of 1 April 2010. Among recent amendments is a new provision on business combinations that should allow the transfer of the trade and assets of a business to be treated as outside the scope of Indonesian VAT (subject to certain conditions). Under previous regulations, the transfer of taxable goods in the context of an acquisition/merger was subject to VAT at the standard rate of 10 percent.

Asset purchase or share purchase

Acquisitions in Indonesia often take the form of a purchase of the shares of a company, as opposed to a trade and asset acquisition. The choice is influenced by both commercial and tax considerations. The sale of shares listed on the Indonesian stock exchange is subject to a final tax at 0.1 percent of gross proceeds. The transfer of titles to land and buildings under an asset purchase subjects the seller to a 2.5 percent final income tax and subjects the buyer to a 5 percent transfer of title tax (duty). Under an approved merger or consolidation, there may be partial (50 percent) relief from the 5 percent transfer of title tax and full relief from the 2.5 percent income tax on land and buildings.

However, there are also a number of benefits for the buyer in a trade and asset acquisition. Under Indonesian tax audit rules, the inheritance of the tax history and liabilities under a share transfer carries significant risk. Further, amortization of goodwill arising on the acquisition of the trade and assets of a business should be tax-deductible.

The sale of unlisted shares held by a foreign shareholder in an Indonesian company is subject to a final tax of 5 percent of gross proceeds, unless protected by a tax treaty.

Purchase of assets

A purchase of assets usually results in an increase in the base cost of those assets for the purposes of both corporate income tax (on the taxable gain) and tax depreciation. The seller is subject to corporate income tax on the gain in asset value at the current rate of 25 percent.

Prior tax liabilities remain with the company and are not transferred with the assets.

Purchase price

For tax purposes, it is necessary to apportion the total consideration among the assets acquired. There are no specific rules for such an apportionment, but the buyer should be aware that the DGT will scrutinize the chosen method.

Goodwill

As with IFRS, under Indonesian GAAP, acquired assets and liabilities (business acquisition) are measured at fair value on the date of acquisition. Goodwill arises on acquisition to the extent that the purchase price exceeds the aggregate of the fair values of the assets, liabilities and contingent liabilities assumed (except for transactions under common control). Such acquired goodwill may be amortized for tax purposes generally for a period of not less than 5 years and up to a maximum of 20 years where a longer period is justifiable under specified conditions. Goodwill should be evaluated for impairment at each balance sheet date.

The acquisition price of goodwill (with a useful life of more than 1 year) should be amortized consistently using either the straight-line or declining-balance method over the useful life of the asset, following the rates of depreciation for tangible assets.

Depreciation

Depreciation is an allowable deduction in determining taxable income. 'Depreciable property' is defined as tangible property that is owned and used in the business or owned for the production, recovery and securing of income and that has a useful life of more than 1 year. Land is not depreciable, except in certain industries.

Depreciable assets other than buildings and construction are classified by tax regulations into one of four asset categories. Buildings and construction are divided into permanent and non-permanent structures. In practice, the regulations define 'useful life', irrespective of the taxpayer's own assessment of the asset's life. Where the category of assets is not specified in the regulations, the asset category may be depreciated based on the useful life. Buildings and other immovable property may only be depreciated using the straight-line method.

For all assets other than buildings and other immovable property, the company can choose to calculate depreciation using either the declining-balance or straight-line method. As outlined above, an application may be made to transfer assets at book value, subject to passing the 'business purpose' test. Where such an application receives the required approval from the DGT, the acquiring company should assume the asset history of the transferor (i.e. the remaining useful life and depreciation method should be recorded and applied by the acquiring company).

Tax attributes

Under a trade and asset sale, the gain on sale proceeds, including any capital gain, is taxed as part of normal income at the corporate income tax rate of 25 percent.

Value added tax (VAT)

Under amended VAT legislation that came into force on 1 April 2010, approved business mergers or consolidations are outside the scope of Indonesian VAT, subject to certain conditions. Professional advice should be sought regarding the applicability of Indonesian VAT to any future transfer of assets. Transfers of the trade and assets of a business outside of an approved merger or consolidation continue to be subject to Indonesian VAT at the standard rate of 10 percent.

Transfer taxes

The transfer of title to land and buildings is subject to a 5 percent non-recoverable title transfer tax (duty). This may be subject to partial (50 percent) relief under an approved merger or consolidation. In addition, a nominal stamp duty tax of 6,000 Indonesian rupiah (IDR) (just under 0.50 US dollars (US$)) is charged on certain legal documents, such as receipts, agreements and powers of attorney.

Purchase of shares

Tax indemnities and warranties

In a share acquisition, the buyer takes over the target company together with all related liabilities and unpaid taxes. Therefore, the buyer needs more extensive indemnities and warranties than where the target's trade and assets are acquired.

Under Indonesian tax legislation, the ITO may conduct an audit within 5 years from the filing date of any tax return. The ITO may re-open a closed tax audit where new documentation or information becomes available.

By international standards, the Indonesian tax audit process is quite aggressive. In a share transaction, this increases the buyer's risk. Professional advice is recommended to ensure the appropriate indemnities and warranties are received and/or the commercial implications are fully considered.

Because of the tax risks outlined above, it is common for a buyer in the Indonesian market to conduct detailed tax due diligence. This process should not only highlight the inherent tax risk but also should provide an agreed tax audit history that can form the basis of the agreed tax indemnities and warranties.

Tax losses

Generally, tax losses may be carried forward for a maximum of 5 years or, for certain business categories, 10 years. Under the new regulations for business mergers, consolidations and expansions, carried forward losses of an Indonesian target cannot be offset against future losses of the acquiring company or merged entity. Such losses expire at the time of acquisition.

Pre-sale dividend

Dividends paid to a resident corporate shareholder holding more than 25 percent of the issued share capital of a company are tax-free. Dividends paid to resident individuals are subject to final tax at 10 percent. As any gain realized on the sale of a business is subject to corporate income tax at 25 percent, a more tax-efficient structure might be achieved by distributing a pre-sale dividend.

Transfer taxes

There is no stamp duty in Indonesia other than the nominal IDR6,000 charge on certain documents. However, the following income taxes and duties apply in certain circumstances.

The sale of shares listed on the Indonesian stock exchange is subject to a final tax at a rate of 0.1 percent of gross proceeds (plus an additional 0.5 percent for founder shares on the share value at the time of the IPO). Certain types of venture capital companies are not required to pay tax on capital gains in certain circumstances.

There is also a final 5 percent tax on gross proceeds from the sale of unlisted shares held by a foreign shareholder in an Indonesian company, unless a tax treaty stipulates otherwise.

Tax clearances

No specific tax clearances are required for acquisitions, except for the application to transfer assets at net book value.

Approval is also required to achieve a partial exemption from the 5 percent tax on the transfer of title to land and buildings under an approved merger or consolidation.

Under the new VAT legislation that came into force on 1 April 2010, clearance is required to treat a transfer of the trade and assets of a business as outside the scope of VAT. KPMG in Indonesia recommends seeking advice on the prevailing legislation before entering such transactions.

Choice of acquisition vehicle

Indonesian corporate law permits foreign companies to invest in a business sector open to foreign investment, by establishing either a joint venture company with a local partner or a wholly owned company. For a purchase by a foreign entity of the shares or trade and assets of a business, investment approval from the BKPM is required. The target company should not operate within a business sector included on the Negative Investment List.

Type of company for foreign investor

A limited liability (PT) company is the most common form of corporate business entity in Indonesia.

A PT company held by a foreign investor is referred to as a foreign investment (PMA) company.

A foreign investor may establish a new PMA company or convert an existing PT company, provided the company operates in an approved sector. The BKPM evaluates investment applications to determine the adequacy of the proposed investment, based on the project's economic feasibility.

Foreign parent company

A foreign parent company may acquire shares in an existing local company, provided the local company's line of business is open to foreign investment. The company format (PMA company) and applicable restrictions are as defined earlier in the report. On exit, a final tax of 5 percent of the gross proceeds applies on the sale of unlisted shares held by a foreign shareholder in an Indonesian company, unless a tax treaty stipulates otherwise.

Dividends and/or interest paid by a local company to the foreign parent are subject to final withholding tax (WHT) of 20 percent, unless a tax treaty stipulates otherwise.

Where a foreign parent company purchases the trade and assets of a business in Indonesia (subject to BKPM approval), this is likely to be deemed a permanent establishment (PE) of the foreign company within Indonesia. Generally, the registered PE of a foreign enterprise is treated as a domestic resident. As such, the domestic WHT rate of 15 percent applies to payments of dividends/interest to the PE. In addition, the PEs of foreign enterprises are subject to 20 percent WHT on their after-tax income unless a reduced treaty rate applies or, in certain cases, the profits are re-invested in Indonesia.

For regulatory purposes, the establishment of a foreign PE is restricted to a limited number of sectors, and approvals from relevant government ministries are required.

Non-resident intermediate holding company

Indonesian regulations to combat tax avoidance through offshoring in tax haven countries include a look-through provision where shares are sold in a company established in a tax haven country that itself holds shares in an Indonesian company. As a result, the sale of a shareholding in a non-resident intermediate holding company may be deemed to be a direct sale of the shares in the Indonesian company and subject to final tax in Indonesia at the rate of 5 percent of the gross proceeds.

Despite these regulations, through careful planning, it may be possible to achieve a non-resident holding structure in a country with an appropriate tax treaty, which may result in lower WHT on dividends or interest and/or a tax-free exit route. The acceptability of such a structure depends on the commercial reality and specifics of the acquisition.

Local branch

Since operating as a PE in Indonesia is restricted to a few specific industries, branch structures for cross-border mergers are rare. PEs of foreign enterprises are subject to 20 percent WHT on their after-tax income unless a reduced treaty rate applies.

There are various types of representative office that may obtain licenses from government authorities. However, they usually are only allowed to perform auxiliary services, such as acting as an intermediary, handling promotional activities and gathering information for a head office abroad. However, KPMG in Indonesia cautions that certain types of representative office are subject to tax in Indonesia. Before establishing a representative office, professional advice is recommended regarding the nature of the license and tax consequences.

Joint venture

A foreign entity may enter into a joint venture through the shared ownership of an Indonesian company with a local partner. The foreign investor cannot create a legal partnership. However, a profit-sharing consortium is permitted for certain sectors and is most common in the construction industry.

There are no additional specific tax considerations for joint ventures beyond those discussed earlier.

Choice of acquisition funding

A buyer using an Indonesian vehicle needs to decide whether to fund the acquisition with debt or equity. Hybrid instruments are not yet a common feature of Indonesian banking functions. The principal tax advantage of debt is the potential tax-deductibility of interest; dividends are not tax-deductible.

Debt

Broadly, a company's accounting treatment for interest is followed for tax purposes, as long as it fairly represents the interest and expenses of the company's loan relationships. Where debt is held through an intercompany loan, the ITO would likely take a detailed interest in the allocated transfer price. Under recent procedural changes, corporate income tax returns must now include detailed information on related-party transactions, including information on both the amount and method of transfer pricing.

Deductibility of interest

Interest on funds borrowed by a company for the purposes of obtaining, collecting and maintaining income is deductible from gross income, except where the loan is used to invest in other companies for which dividend income is not taxable.

The DGT has the authority to re-determine the amount of interest income and/or interest expense and to reclassify debt as equity in determining taxable income where a taxpayer has a special relationship with another taxpayer. These provisions aim to prevent the taxpayer from reducing tax by charging excessive interest costs (e.g. interest rates in excess of commercial rates) between related parties. Interest-free loans from shareholders are allowed, subject to certain conditions.

Where those conditions are not met, the borrower risks the imposition of deemed interest and WHT obligations.

Withholding tax on debt and methods to reduce or eliminate it

WHT is imposed at 20 percent on various amounts payable to non-residents (including dividends and interest), unless the non-resident has a registered PE in Indonesia, in which case the rates applicable to payments to residents apply. The WHT may be reduced where the foreign resident is exempt or eligible for a reduced WHT rate by virtue of a tax treaty.

In order to qualify for treatment under a tax treaty, non-resident status should be supported with a certificate of domicile (COD) issued by the competent authority of the non-resident's country of domicile. A specific form is provided for this (DGT-1 for most taxpayers). In addition to details of tax residence, the form requires detailed declarations regarding substance and beneficial ownership that the recipient is required to positively affirm in order be able to make use of the tax treaty benefits.

Payments of interest by an Indonesian company to a resident company (including a registered PE of a foreign entity) are subject to WHT at 15 percent.

Checklist for debt funding

— Interest is only deductible where the borrowed funds are used to generate taxable income for the entity.

— The use of Indonesian bank debt may avoid thin capitalization problems.

— Consider whether the level of profitability would enable tax relief for interest payments to be effective.

— Domestic and international payments of interest are subject to 15 percent and 20 percent WHT respectively.

Equity

A buyer may use equity to fund its acquisition, possibly by issuing shares to the seller in satisfaction of the consideration or by raising funds through a seller placing. Further, the buyer may wish to capitalize the target after the acquisition. The use of equity, rather than debt, offers less flexibility should the parent subsequently wish to recover the funds it has injected, for example, because capital reductions may be troublesome and there may not be a market for the shares at the price required. However, equity may be more appropriate where the potential target is loss-making as there would be no immediate tax benefit from interest deductions.

Other considerations

Thin capitalization

Where a special relationship exists, interest may be disallowed as a deduction if the charges are considered in excess of commercial rates. Interest-free loans from shareholders that do not meet certain conditions may create a risk of interest being deemed, resulting in WHT obligations for the borrower.

In 2015, the Minister of Finance has issued thin capitalization rules regarding finance expenses that can be deducted when calculating corporate income tax payable, setting a maximum debt-to-equity ratio (DER) of 4:1, as from fiscal year 2016.

Specific provisions define 'debt' and 'equity' for the DER calculation as follows:

Debt

— is the average of month-end outstanding debt balances in a tax/fiscal year or part of a fiscal year

— includes short-term and long-term debt and interest-bearing trade payables (KPMG in Indonesia believes the definition includes interest bearing-loans from third parties)

— excludes non-interest-bearing related-party loans.

Equity

— is the average of month-end equity balances in a fiscal year or part of a fiscal year, determined in accordance with Indonesian Financial Accounting Standards, plus

— the average of month-end outstanding debt balances in a tax/fiscal year or part of a fiscal year of non-interest-bearing related-party loans.

The following corporate taxpayers are exempt from the thin capitalization rules:

— banks, including the Bank of Indonesia

— financial institutions/leasing companies that engage in providing funds and/or capital goods

— insurance and reinsurance companies, including Sharia-compliant insurance and reinsurance companies

— oil and gas and mining companies under a contract of work, production-sharing contract and other agreement with the government that have specific DER provisions (if such provisions do not exist, the taxpayer is not exempt from the 4:1 DER requirement)

— companies subject to a final tax regime

— companies engaged in infrastructure businesses.

Group relief/consolidation

There are no provisions for grouping or consolidation under Indonesian tax law. Under the regulations issued in 2008, losses may not be transferred to a separate entity on a merger.

Transfer pricing

Any transaction determined to be non-arm's length may be subject to adjustment by the DGT. Such transactions include unreasonable purchase/sales prices, unreasonable

interest rates applied to intercompany loans, and purchases of a company's assets by shareholders (owners) or parties having a special relationship at prices that are higher or lower than market prices. A special relationship includes common ownership or control (direct or indirect) of 25 percent or more of the capital of another party and a family relationship. The transfer pricing rules apply to certain domestic and international transactions.

Among many recent procedural changes to corporate income tax return filing requirements, additional requirements are imposed on the format of disclosures for related-party transactions. These changes are in line with the ITO's increasing focus on transfer pricing requirements since 2007. Regulations issued in 2010 and 2011 further expand on this focus and require that documentation that is largely in line with the Organisation for Economic Cooperation and Development's (OECD) guidelines is available for submission to the DGT.

In December 2016, Indonesia issued Regulation PMK-213, which implements the OECD BEPS Action 13 initiative. These reporting requirements may require foreign groups with activities in Indonesia to prepare three documents regarding related-party transactions:

— a master file

— a local file

— a country-by-country (CbyC) report.

The master and local files must be available 4 months after fiscal year-end, in either Bahasa or English (however, an English version must be accompanied by Bahasa translation). The CbyC report is due within 1 year after fiscal year-end. A master and local file is required if a taxpayer conducts:

— any related-party transactions and its gross revenue was above IDR50 billion in the previous year

— related-party tangible goods transactions of more than IDR20 billion

— related-party non-tangible goods transactions of more than IDR5 billion

— related-party transactions of any amount with a party in a jurisdiction with a lower corporate tax rate than Indonesia's tax rate (i.e. 25 percent); a list of these jurisdictions has been published by the ITO.

A CbyC report is mandated if a taxpayer is:

— a parent entity with consolidated group revenue of more than IDR11 trillion (among Indonesian group companies)

— part of a foreign parent entity:

  — that is not required to submit a CbyC report

  — that is in a country that does not have an information exchange agreement with Indonesia, or for which the ITO is unable to obtain a CbyC report through an information exchange agreement.

The ITO has published a list of countries that have suitable exchange of information arrangements. PMK 213 includes an extensive list of information to be disclosed in the CbyC report. Recently, the ITO has been taking an aggressive approach to transfer pricing issues.

Foreign investments of a local target company

Indonesia's controlled foreign company (CFC) rules define a CFC as a foreign unlisted corporation in which Indonesian resident individual or corporate shareholders, either individually or as a group, hold (directly or indirectly) 50 percent or more of the total paid-in capital. Listed corporations are not CFCs. The Indonesian shareholders are deemed to receive dividends within 4 months of filing the tax return, or 7 months after the end of the fiscal year where there is no obligation to file an annual tax return or there is no specific filing deadline in the CFC's country of residence.

Comparison of asset and share purchases

Advantages of asset purchases

— Buyer does not acquire the tax history and liabilities of the target company.

— Amortization of acquired goodwill should be deductible for tax purposes.

— Under the amended VAT legislation, the transfer of the trade and assets of a business in an approved merger or consolidation is outside the scope of VAT as of 1 April 2010.

— Under certain conditions, the acquired assets may be transferred at net book value, thereby achieving a tax-neutral transfer.

Disadvantages of asset purchases

— The transfer of title to land and buildings could be subject to 2.5 percent final income tax and 5 percent title transfer tax (duty).

— Under current VAT legislation, the transfer of the trade and assets of a business is subject to VAT at the standard rate of 10 percent.

Advantages of share purchases

— Likely more attractive to the seller, commercially and from a tax perspective, so the price may be lower.

— Usually a lower capital outlay (purchase of net assets only).

— Sales of shares listed on the Indonesian stock market are subject to a final tax rate of only 0.1 percent of gross proceeds.

— Sales of shares are exempt from VAT.

Disadvantages of share purchases

— Buyer acquires the tax history and liabilities of the target company.

— Sales of unlisted shares by a foreign company are subject to a final tax of 5 percent of the gross proceeds unless a tax treaty stipulates otherwise. Consequently, the seller is liable for the tax even where the shares are sold at a loss.

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Japan

Introduction

This report provides insight into tax issues that need to be considered when considering mergers and acquisitions (M&A) in Japan.

Recent developments

Japan has been reducing corporate income tax rates for the last few years. The effective corporate tax rate has dropped to about 30 percent. To make up for the lost tax revenues, various countermeasures have been introduced, including a limitation on the amount of tax-deductible losses carried forward in a year.

In addition, the consumption tax rate rose to 8 percent (from 5 percent) on 1 April 2014 and is scheduled to increase to 10 percent on 1 October 2019.

Asset purchase or share purchase

The following sections discuss issues that need to be considered from a Japanese tax perspective when considering a purchase of either assets or shares. The advantages and disadvantages of each alternative are summarized at the end of this report.

Purchase of assets

In an asset deal, the selling entity realizes a gain or loss in the amount of the difference between the sale price and the tax book value of the assets sold, and the assets have a new base cost in the buyer's hands.

Purchase price

For tax purposes, in an asset deal, the purchase price is among individual assets based on their market values. In a purchase of a business, the excess of the purchase price over the total of the values allocated to each individual asset is treated as goodwill for tax purposes. Any excess of the total of values of the individual assets over the purchase price is negative goodwill for tax purposes.

Goodwill

For tax purposes, goodwill recognized in a purchase of business should be amortized over 5 years (20 percent of the base cost annually). The amortization is deductible. Negative goodwill should also be amortized over 5 years (20 percent of the base cost annually), and the amortization should be treated as taxable. Unlike the depreciation of tangible assets or the amortization of intangible assets explained later in this report, the amortization of goodwill or negative goodwill recognized in a purchase of business for tax purposes is not affected by the accounting treatment.

Depreciation

Generally, a company may select either the straight-line or declining-balance method to compute the depreciation of each class of tangible assets. The default depreciation method for most assets is the declining-balance method. For buildings and certain leased assets, the straight-line method must be used. Intangible assets also must be amortized using the straight-line method.

The depreciation and amortization allowable for tax purposes is computed based on the statutory useful lives of the assets provided in a Ministry of Finance ordinance. For second-hand assets, shorter useful lives could be applied.

The depreciation or amortization must be recorded in the statutory books of account to claim a tax deduction. The amount of depreciation or amortization exceeding the allowable limit for tax purposes must be added back to the profits in calculating taxable income. If the book depreciation or amortization amount is less than the allowable amount for tax purposes, no adjustment is required, and the asset's useful life is effectively extended for tax purposes.

Tax attributes

Tax losses and other tax attributes are not transferred to the buyer in an asset deal.

Value added tax

Japanese consumption tax, similar to valued added tax (VAT), is levied on a sale or lease of an asset and supply of service in Japan. The current consumption tax rate is 8 percent. Certain transactions are specifically excluded, such as sales of land and securities. A sale of business in Japan is treated as a sale of individual assets for consumption tax purposes and should be subject to consumption tax, depending on the type of asset transferred. A sale of goodwill in Japan is taxable for consumption tax purposes.

When the consumption tax rate rises to 10 percent (from 8 percent) on 10 October 2019, a multiple tax rate system will be introduced, applying a reduced rate of 8 percent to sales of food/beverages (excluding alcoholic beverages) and certain newspapers under subscription contracts.

Transfer taxes

Stamp duty is levied on business transfer agreements, with the stamp duty determined according to the value stated in the agreement. The maximum amount of stamp duty is 600,000 Japanese yen (JPY).

If real estate is transferred in a business transfer, registration tax and real estate acquisition tax are levied. These taxes are subject to a number of temporary reductions and reliefs, and the tax rates differ depending on the type of acquiring entity (e.g. trust, special-purpose vehicle). Where the acquiring entity is an ordinary corporation, registration tax is levied in principle at 2 percent of the property's appraised value. For land, the tax rate is reduced to 1.5 percent until 31 March 2019.

Real estate acquisition tax is levied at 4 percent of the appraised value of the property. This rate is reduced to 3 percent until 31 March 2018 for land and residential buildings. Further, when land is acquired by 31 March 2018, its tax base is reduced by 50 percent.

Purchase of shares

In a share purchase, the buyer does not achieve a step-up of the base cost of the target company's underlying assets.

Tax indemnities and warranties

In a share purchase, the buyer takes over the target company's liabilities, including contingent liabilities. In negotiated acquisitions, the buyer usually requests, and the seller provides, indemnities or warranties for any undisclosed tax liabilities of the target company. The extent of the indemnities and warranties is a matter for negotiation. When an acquisition is made by way of a hostile takeover, the nature of the acquisition makes it impossible to seek warranties or indemnities.

Tax losses

Tax losses may be carried forward for 9 years (10 years for losses incurred in fiscal years beginning on or after 1 April 2018).

The deductible amount of tax losses is limited to 55 percent (50 percent for fiscal years beginning on or after 1 April 2018) of taxable income for the fiscal year.

For small and medium-sized companies and tax-qualifying *Tokutei Mokuteki Kaisha* (TMK) and *Toushi Hojin* (TH), etc., tax losses are deductible up to the total amount of taxable income for the year.

For Japanese corporate tax purposes, there is no distinction between revenue income and capital income.

Restrictions could apply on the carry forward of losses where more than 50 percent of the ownership of a company with unused tax losses changes hands. These restrictions only apply where, within 5 years after the change of ownership, one of several specified events occurs, such as the acquired company ceases its previous business and starts a new business on a significant scale compared to the previous business.

Japanese tax law also provides for a tax loss to be carried back for 1 year at the option of the taxpaying company. This provision was suspended as of 1 April 1992, except in certain situations, such as dissolution and for small and medium-sized companies.

Crystallization of tax charges

If the target company belonged to a 100 percent group, deferred gains and losses of the target company relating to transfers of assets to other entities within the 100 percent group crystallize in the target company when the target company leaves the 100 percent group as a result of the acquisition.

Pre-sale dividend

Where the seller is a Japanese corporation, the seller may prefer to receive part of the value as a pre-sale dividend rather than sale proceeds. Capital gains from the sale of shares are subject to corporate tax at approximately 30 percent.

However, domestic dividend income less interest expenses deemed incurred for holding the shares (net dividend income) is exempt from corporate tax, provided the Japanese seller corporation held more than one-third of the Japanese target company. A 20 percent exemption applies for shareholdings of 5 percent or less, and a 50 percent exemption applies in all other cases. Domestic dividend income received within a 100 percent group is entirely excluded from taxable income without deducting interest expenses attributable to the dividend.

Transfer taxes

No stamp duty is levied on the transfer of shares. However, if the target issues share certificates for transfer, stamp duty applies to the certificates' issuance. The amount of stamp duty depends on the stated value of the certificate, to a maximum liability per share certificate of JPY20,000.

Tax clearances

It is not necessary to obtain advance clearance from the tax authorities for acquisitions or disposals of shares. For complex or unusual transactions, the parties may decide to seek a ruling from the tax authorities (generally, verbal) to confirm the proposed tax treatment.

Choice of acquisition vehicle

The following vehicles may be used for an acquisition by a foreign buyer. When establishing an ordinary domestic company (*Kabushiki Kaisha or Godo Kaisha*), registration tax is charged at 0.7 percent of share capital (not including capital surplus), while establishing a branch of a foreign company is generally subject to registration tax of JPY90,000.

Local holding company

If the buyer wishes to offset financing costs for the acquisition against the Japanese target company's taxable income, a Japanese holding company may be set up as an acquisition vehicle. The offset would be achieved through either a tax consolidation, which allows an offset of losses of one company against profits of other companies in the same group, or a merger. The tax consolidation system in Japan is explained in the section on 'Other considerations' later in this report. For discussion of the tax implications of a merger, see 'Equity'.

Foreign parent company

If the foreign buyer wishes to offset the financing costs for the acquisition against its own taxable profits, the foreign buyer may choose to acquire the Japanese target company directly. In this case, the Japanese tax implications should be considered for dividends from the target company to the foreign parent company and for capital gains to be realized when the foreign parent company disposes of the target company in the future.

Japanese withholding tax (WHT) is imposed on dividends paid by a Japanese non-listed company to its foreign shareholders at the rate of 20 percent under Japanese domestic law. Reduced rates are available under Japan's tax treaties. A special reconstruction income tax is imposed on WHT at 2.1 percent from 2013 to 2037, except for cases where the WHT rate is reduced under a tax treaty.

Capital gains from the sale of shares in a Japanese company by a foreign corporate shareholder without a permanent establishment in Japan are subject to Japanese national corporation tax where:

— the foreign shareholder and its related parties owned 25 percent or more of the outstanding shares at any time during the previous 3 years, including the year of sale, and sold 5 percent or more of the outstanding shares of the Japanese company in a specific accounting period

— more than 50 percent of the Japanese company's total property consists of real estate located in Japan on a fair market value basis.

Some of Japan's tax treaties exempt foreign shareholders from taxation on capital gains in Japan.

Non-resident intermediate holding company

If the foreign parent company could be subject to significant tax in Japan and/or its home country if it directly holds the Japanese target company, an intermediate holding company in another country could be used to take advantage of benefits of tax treaties. However, interposing an intermediate holding company for the sole purpose of enjoying tax treaty benefits could be regarded as treaty shopping and application of the treaty could be disallowed. The Japanese government has recently been updating its tax treaties, and many now contain limitation on benefits (LOB) and principal purpose test (PPT) clauses.

Local branch

A foreign corporation operating in Japan through a branch is liable for corporate income taxes only on the income attributable to the branch, which is calculated in line with the Authorized OECD Approach (AOA). Generally, there is no material difference in the tax treatment of a branch of a foreign corporation and a corporation organized under Japanese law. The methods for computing taxable income, tax-deductible provisions and reserves, limitations on allowable expenses (e.g. entertainment expenses and donations) and corporate income tax rates are the same for both a branch and a corporation.

Joint venture

A joint venture generally is either a Japanese corporation with joint venture partners holding shares in the Japanese corporation or a *Nin-i Kumiai* (NK, similar to a partnership) with joint venture partners holding interests in the NK. In Japan, an NK is not recognized as a separate taxable entity and the partners are liable for Japanese tax on the basis of their share of profits under an NK agreement and in accordance with their own Japanese tax status.

Choice of acquisition funding

Debt

Interest paid or accrued on debt, including an intercompany loan, generally is deductible for the paying corporation, but there are exceptions, particularly for an intercompany loan from a foreign shareholder or affiliate.

Deductibility of interest

The thin capitalization rule restricts the deductibility of interest payable by a Japanese subsidiary to its overseas controlling shareholders or affiliates. The safe harbor is the debt-to-equity ratio of 3:1. Where loans from the overseas controlling shareholders or affiliates cause the ratio to be exceeded, interest expenses calculated on the excess debt are not deductible for Japanese corporation tax purposes.

Third-party debts may also be subject to the thin capitalization rule, including:

— back-to-back loans from overseas controlling shareholders through third parties

— debts from a third party with a guarantee by overseas controlling shareholders

— debts from a third party provided through bonds borrowed from overseas controlling shareholders as collateral for the debts.

In lieu of the 3:1 ratio, a company may use the debt-to-equity ratio of a comparable Japanese company where a higher ratio is available.

In addition, an earnings-stripping rule aims to prevent tax avoidance by limiting the deductibility of interest paid to

related persons where it is disproportionate to income. Under the rule, where 'net interest payments to related persons' exceed 50 percent of 'adjusted taxable income', the excess interest expense is disallowed and can be carried forward for up to 7 years.

Interest paid to overseas shareholders or affiliates should also be reviewed from a transfer pricing perspective.

Withholding tax on debt and methods to reduce or eliminate it

Under Japanese tax law, the WHT rate on interest payable to a non-resident is 20 percent. A special reconstruction income tax is imposed on WHT at 2.1 percent from 2013 to 2037, except where the WHT rate is reduced under a tax treaty.

To obtain the reduction of Japanese WHT under a tax treaty, the recipient or their agent should submit an application form for relief from Japanese income tax to the competent authority's tax office through the payer corporation before the date of payment.

Checklist for debt funding

— Consider whether interest should be treated as fully deductible from a thin capitalization/earnings-stripping perspective.

— Consider whether interest should be treated as fully deductible from a transfer pricing perspective.

— The use of bank debt may avoid thin capitalization and transfer pricing problems unless there are back-to-back arrangements or guarantees by a related party.

— Consider whether the level of profits would enable tax relief for interest payments.

— WHT of 20 percent (and the special reconstruction income tax imposed on WHT at 2.1 percent from 2013 to 2037) applies on interest payments to foreign entities unless a lower rate applies under a tax treaty. To apply a treaty rate, an application form must be submitted to the tax office before making the payment.

Equity

Dividends paid by an ordinary Japanese company are not deductible. Under domestic law, WHT is imposed on dividends paid by a Japanese company to its foreign shareholders at 20 percent. WHT on dividends from certain listed companies is reduced to 15 percent. Reduced tax rates are available under Japan's tax treaties — see the table of treaty withholding tax rates at the end of this report.

Bear in mind the special reconstruction income tax imposed on WHT at 2.1 percent from 2013 to 2037, except where the WHT rate is reduced under a tax treaty.

Japanese corporate tax law provides for a specific regime for corporate reorganizations, summarized in the next section.

Tax-qualified versus non-tax-qualified reorganizations

The corporate reorganization regime provides definitions of 'tax-qualified' and 'non-tax-qualified' reorganizations for the following transactions:

— corporate division (spin-off and split-off)

— merger

— contribution in kind

— share-for-share-exchange (*kabushiki-kokan*) or share transfer (*kabushiki-iten*)

— squeeze-out

— dividend in kind

— share dividend.

Under a tax-qualified reorganization, assets and liabilities are transferred at tax book value (i.e. recognition of gains/losses is deferred) for tax purposes, while under a non-tax-qualified reorganization, assets and liabilities are transferred at fair market value (i.e. capital gains/losses are realized) unless the reorganization is carried out among a 100 percent control relationship. Where a share-for-share-exchange, share transfer or squeeze-out is carried out as a non-tax-qualified reorganization, built-in gains and losses in assets held by the subsidiaries are crystallized, although assets and liabilities are not transferred and remain in the subsidiary unless the parent company and the subsidiaries had a 100 percent control relationship.

The table below outlines the general conditions required for a tax-qualified merger:

Relationship	Conditions
(1) 100 percent control relationship	(a) Only shares in the surviving company are distributed as consideration for the transfer (no-boot requirement — see below). (b) The 100 percent control relationship is expected to remain.
(2) More than 50 percent control relationship	(a) Same as (1)-(a). (b) The more than 50 percent control relationship is expected to remain. (c) Approximately 80 percent or more of directors and employees of the merged company are expected to be engaged in the business of the surviving company. (d) The surviving company is expected to continue to operate the main business of the merged company.

(3) 50 percent or less relationship	(a) Same as (1)-(a), (2)-(c) and (d). (b) One of the main businesses of the merged company has a relationship with one of the businesses of the surviving company. (c) The relative business size (i.e. sales, number of employees, etc.) of the related businesses is not considerably different (within a 1:5 ratio), or at least one of the senior directors from both the merged company and surviving is expected to become a senior director of the surviving company after the merger. (d) Where one of the shareholders of the merged company held more than 50 percent of the shares in the company before the merger, that shareholder is expected to continue to hold the shares in the surviving company received due to the merger.

Source: KPMG in Japan, 2018

For the no-boot requirement discussed in (1)-(a):

— In a triangular merger, where shares in the parent company that directly holds 100 percent of the shares in the surviving company are distributed instead of shares in the surviving company, the no-boot requirement is satisfied in principle.

— Where the surviving company held more than two-thirds of the shares in the merged company before the merger, even if minority shareholders receive boot, the no-boot requirement is not jeopardized (the 2/3 exceptional rule).

Pre-reorganization losses

Under a tax-qualified merger, where certain conditions are met, pre-merger losses are transferred from the merged company to the surviving company. Otherwise (i.e. under a non-tax-qualified merger or other tax-qualified merger that does not satisfy certain conditions), such losses cannot be transferred.

Where the merger is tax-qualified, pre-merger losses incurred in the surviving company can be used against future profits after the reorganization, where certain requirements are met. There are no such requirements for non-tax-qualified mergers. This rule also applies to pre-reorganization losses incurred in the transferee company in the case of a corporate division and contribution in kind.

A number of rules restrict the use of built-in losses after a reorganization in certain circumstances.

Taxation of shareholders

When the shareholders receive only shares in the transferee company or only shares in the parent company of the transferee company (in triangular reorganizations), capital gains and losses from the transfer of the shares are deferred in principle. In a merger, split-off or share-dividend, where the reorganization is non-tax-qualified, the shareholders of the transferor company recognize a deemed receipt of dividends.

Hybrids

Hybrid instruments are deemed to be either shares, which are treated as equity, or debt, which is subject to the accrual rules. The major types of instruments and their treatment for tax purposes are as follows:

Type	Treatment
Convertible bonds	Debt, subject to accrual rules
Perpetual debt	Debt, subject to accrual rules
Subordinated debt	Debt, subject to accrual rules
Preference shares	Equity

Source: KPMG in Japan, 2018

Discounted securities

Generally, the issuer of discounted securities obtains a tax deduction for the discount accruing over the life of the securities, while the lender recognizes taxable income accruing over the life of the securities. However, the tax treatment of discounted securities could be different, and each case should be analyzed on its facts.

Deferred settlement

Earn-out arrangements that defer part of the consideration and link its payment to the performance of the acquired business are not uncommon in acquisitions. Generally, the seller recognizes gains as they are realized, but the tax treatment of such a deferred settlement varies case-by-case, and each case should be analyzed on its facts.

Other considerations

Concerns of the seller

The seller's concerns or preferences about how to structure the deal are affected by various factors, including the seller's tax position and whether it is an individual or corporation. For example, where the seller is a Japanese resident individual, capital gains from the sale of shares of a Japanese non-listed company are taxed at 20 percent (15 percent income tax and 5 percent inhabitant tax, plus the 2.1 percent special reconstruction income tax imposed on the income tax liability from 2013 to 2037.

Where the Japanese non-listed company in which the Japanese individual holds shares sells assets and distributes the sale proceeds as a dividend to the shareholder, generally,

the company is subject to corporate tax at approximately 30 percent on the gains from the sale of assets. The shareholder then is subject to income tax on dividend income distributed out of the company's after-tax profits at a maximum of approximately 55 percent. In this case, a Japanese individual seller may prefer a share deal to an asset deal. The position is not straightforward, and professional advice should be sought.

Group relief/consolidation

Consolidated tax return filing system

A group of companies may elect to file consolidated tax returns. A group is made up of a Japanese parent company and its 100 percent directly or indirectly owned Japanese subsidiaries. Non-Japanese companies are excluded from the consolidated group. To become a consolidated group, an election needs to be made to the tax office in advance. The tax consolidation system is applicable to national corporation tax only, and each company in a consolidated group is required to file local tax returns individually.

Consolidation allows for the effective offset of losses incurred by one company against profits of other companies in the same group. Consolidated tax losses can be carried forward and offset against future consolidated profits for up to 9 years (10 years for losses incurred in fiscal years beginning on or after 1 April 2018).

In principle, losses incurred by subsidiaries before joining the consolidated group expire on joining, but there are exceptions. Prior losses incurred by certain subsidiaries (e.g. a subsidiary held by the parent for over 5 years) may be utilized by the consolidated group up to the amount of post-consolidation income generated by the subsidiary.

At the time of joining a consolidated group, a subsidiary is required to revalue its assets to fair market value and recognize taxable gains or losses from the revaluation for tax purposes except in certain cases, including where the subsidiary has been held by the parent company for over 5 years.

Group taxation regime

The group taxation regime automatically applies to certain transactions carried out by Japanese companies belonging to a 100 percent group (i.e. a group of companies that have a direct or indirect 100 percent shareholding relationship), including a tax-consolidated group. In principle, the group taxation regime applies only to transactions between Japanese companies in a 100 percent group.

Capital gains/losses arising from a transfer of certain assets (e.g. fixed assets, securities, monetary receivables and deferred charges excluding those whose tax book value just before the transfer is less than JPY10 million) within a 100 percent group are deferred. The deferred capital gains/losses are realized by the transferor company, for example, where the transferee company transfers the assets to another person or where the transferor or transferee company leaves the 100 percent group.

Donations between companies in a 100 percent group are not taxable income for the recipient company and are a non-deductible expense for the company paying the donation.

Domestic dividends paid between companies in a 100 percent group are fully excluded from taxable income without deduction of associated interest expenses. In the case of dividends in kind paid in a 100 percent group, no capital gains/losses from the transfer of assets are recognized (tax-qualified dividend in kind).

In certain cases, including where a company repurchases its own shares from another company in a 100 percent group or where a company liquidates and distributes its assets to another company in a 100 percent group, the shareholder company does not recognize capital gains/losses on surrendering the shares. Tax losses of the liquidated company may be transferred to its shareholder company on liquidation.

Transfer pricing

Japan's domestic transfer pricing legislation aims to prevent tax avoidance by companies through transactions with their foreign related companies. Generally, the tax authorities require all intragroup transactions to be carried out in accordance with the arm's length principle.

By virtue of the 2016 tax reform, a three-tiered approach (local file, master file and country-by-country file) was adopted based on the OECD's final recommendations under its Action Plan on Base Erosion and Profit Shifting (BEPS).

Foreign investments of a local target company

The Japanese CFC regime was amended under the 2017 tax reform. The new CFC regime applies for fiscal years beginning on or after of a controlled foreign company (CFC), which is a foreign company of which more than 50 percent is held by Japanese residents or a foreign company that has a de facto control relationship with Japanese residents.

Under the new CFC regime, where a Japanese parent company holds at least 10 percent of the shares in a CFC, the Japanese parent company is required to include its proportionate share of the income of the CFC in its taxable income. The scope of income of a CFC to be included depends on the characteristics and the effective tax rate of the CFC:

— Where a CFC is a 'specified CFC' (i.e. a paper company, a cash-box company or a company whose head office is located in a black-list jurisdiction) and the effective tax rate of the CFC is less than 30 percent, the entire income of the CFC is included in taxable income of its Japanese parent company.

— Where a CFC is not a specified CFC and does not satisfy the economic activity tests and the effective tax rate of

the CFC is less than 20 percent, the entire income of the CFC is included in taxable income of its Japanese parent company.

— Where a CFC is not a specified CFC and satisfies the economic activity tests and the effective tax rate of the CFC is less than 20 percent, only passive income of the CFC is included in taxable income of its Japanese parent company.

Comparison of asset and share purchases

Advantages of asset purchases

— Goodwill may be recognized and amortized for tax purposes.

— Fixed assets may be stepped-up and depreciated or amortized for tax purposes (except for land).

— No previous liabilities of the target company are inherited.

— Possible to acquire only part of a business.

Disadvantages of asset purchases

— Capital gains, including those arising from goodwill, are taxable for the seller, so the price could be higher.

— Real estate acquisition tax and registration tax are imposed.

— Consumption tax (VAT) arises on certain asset transfers.

— Benefit of any losses incurred by the target company remains with the seller.

Advantages of share purchases

— Legal procedures and administration may be simpler, making this more attractive to the seller and thus reducing the price. Buyer may benefit from tax losses of the target company.

— No consumption tax (VAT) is imposed.

— Where the seller is non-Japanese, Japanese tax on capital gains from the sale of shares in the Japanese target company could be exempt, depending on Japan's tax treaty with the country in which the seller is located.

— Buyer may gain the benefit of existing supply and technology contracts and licenses or permissions.

Disadvantages of share purchases

— Liable for any claims or previous liabilities of the target company.

— No deduction is available for the purchase price.

— Step-up of the target company's underlying assets is not possible. Amortizable goodwill is not recognized.

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Korea

Introduction

Opportunities for mergers and acquisitions (M&A) in the Republic of Korea (Korea) have increased in recent years. A growing number of companies are turning their attention to M&A to compete in the global economy, expand operations and gain synergistic benefits. As the number of M&A deals in Korea grows, the Korean government continues to provide tax and other benefits to encourage them. Regarding the taxation of cross-border M&A, this report focuses on the following issues:

— asset purchase or share purchase

— choice of acquisition vehicle

— choice of acquisition funding.

Tax is only one part of transaction structuring. The Korean Commercial Law governs the legal form of a transaction, and accounting issues are also highly relevant when selecting the optimal structure. Investors who are planning cross-border M&A should consider these other matters as well.

Asset purchase or share purchase

Investors may purchase a company by way of an asset purchase or a share purchase. Each method has its own tax advantages and disadvantages.

Purchase of assets

Under Korean tax laws, there are two main types of asset purchases — individual asset transfers and comprehensive business transfers. Where, at the seller/buyer's discretion, only selected assets or liabilities are transferred, the transfer is classified as an individual asset transfer. By contrast, where substantially all the business-related rights, assets, liabilities and employees of a company or a division of a company are transferred, such that the nature and continuity of the business are sustained after the transfer, the transaction is deemed to be a comprehensive business transfer for Korean tax purposes.

Purchase price

Assets and liabilities are valued in the course of an asset purchase, which may result in a capital gains tax liability for the seller and affect the depreciable amount for the buyer. Where a comprehensive business is purchased at its fair market value, the acquisition cost of the target business's assets may be stepped-up (or down) to their fair market value. In this case, the buyer needs to apportion the total consideration to the assets acquired.

Goodwill

Goodwill is the excess amount of the consideration paid over the fair value of the net assets transferred. For tax purposes, goodwill can only be recognized if it is traceable to a valuable intangible asset and if an appropriate method has been used to calculate the goodwill. Goodwill can be amortized on a straight-line basis over a period of 5 years or more within the tax limit to the extent that the amortization expenses are recognized for accounting purposes.

Depreciation

The depreciation cost of the assets recognized in the accounts is deductible for tax purposes within the tax limit, provided it is calculated based on the depreciation method and useful life stipulated for each type of asset under the corporate income tax law. Taxpayers typically choose the straight-line method, declining-balance method or unit of production method to depreciate assets.

Tax attributes

Tax losses and historical tax liabilities are not transferred with the assets in an asset acquisition. On an individual asset transfer, the buyer does not incur a secondary tax liability for any unpaid tax or tax liabilities of the seller that relate to the transferred assets on the official transfer date. However, in a comprehensive business transfer, the buyer assumes a secondary tax liability on any already fixed and determinable tax liabilities of the seller on the official transfer date.

Value added tax

Value added tax (VAT) implications arising on an asset transfer depend on whether the transfer is classified as an 'individual asset transfer' or 'comprehensive business transfer' under Korean tax law. On an individual asset transfer, the seller should withhold VAT at 10 percent from the buyer and remit the collected VAT to the relevant tax authority. A comprehensive business transfer is exempt from VAT.

Transfer taxes

Stamp duty

Stamp duty is levied on the transfer of certain assets listed in the stamp duty law. The rate of stamp duty varies according

to the asset acquired. Transfers of real estate are subject to stamp duty ranging from 20,000 to 350,000 Korean won (KRW), depending on the acquisition price.

Acquisition tax

Under the Korean Local Tax Law, a company acquiring land, buildings, vehicles or certain memberships (e.g. golf memberships, condominium memberships and/or sports complex memberships) is liable for acquisition tax, based on the transfer price, type and location of such taxable assets. In certain cases, the applicable acquisition tax rate is higher than the normal rate.

Purchase of shares

Under Korean tax law, the following tax implications may arise on the transfer of shares.

Tax indemnities and warranties

In a share transfer, the buyer takes over all assets and related liabilities together with contingent asset and liabilities. Therefore, the buyer normally requires more extensive indemnities and warranties than in the case of an asset transfer.

Tax losses

In principle, on a change of ownership, the tax losses of a Korean company transfer along with the company.

Crystallization of tax charges

Since the purchase in a share transfer should assume the historical tax liability of the target company for the previous periods within the statute of limitations in Korea, it is usual for the buyer to obtain an appropriate indemnity from the seller.

Transfer taxes

Security transaction tax

A securities transaction tax (STT) is imposed on the transfer of stock of a corporation established under the Commercial Code or any special act, or on the transfer of an interest in a *Yuhan Hoesa*, Hapmyong Hoesa or Hapja Hoesa established under the Commercial Code. The securities settlement corporation and securities companies are required to collect tax at the time of a transaction. The tax is computed by multiplying the tax base by the tax rate (0.15 percent, 0.3 percent or 0.5 percent). For related-party transactions, where the transfer price is lower than the fair market value, the fair market value is used as the tax basis for calculating STT.

Deemed acquisition tax

On a share transfer, no acquisition tax is generally levied. An exception applies where the invested company has certain underlying assets (e.g. land, buildings, structures, vehicles, certain equipment, various memberships) that are subject to acquisition tax specifically defined under the relevant law. Where the investor and its affiliates collectively acquire in aggregate more than 50 percent of the shares in the target company, they are deemed to have indirectly acquired those taxable properties through the share acquisition and become subject to deemed acquisition tax.

Tax clearances

It is possible to obtain a tax clearance certificate from the Korean tax authority to confirm whether there are outstanding tax liabilities as of the tax clearance certificate issuance date.

Choice of acquisition vehicle

Several acquisition vehicles are available to a foreign investor. The tax burden may differ according to the type of acquisition vehicle.

Local holding company

A local holding company may be used as a vehicle for the acquisition of a local company. In this case, by borrowings, the local company can deduct the interest expense against its taxable income within the limits prescribed by Korean tax law. Where the debt is borrowed from a related foreign shareholder, the interest rate should be set at an arm's length rate equal to the market rate.

The general types of the business entity include the following (among others).

Chusik Hoesa

The *Chusik Hoesa* is the business organization permitted to issue shares to the public, so it is the most common form of business entity in Korea.

Yuhan Hoesa

A *Yuhan Hoesa* is organized by one or more partners who have signed on its articles of incorporation (AoI) for their participation with limited liability. One advantage of a *Yuhan Hoesa* is that it may be possible to obtain flow-through tax treatment for US tax purposes. A *Yuhan Hoesa* is eligible to make a check-the-box election under US tax law.

Hapmyong Hoesa

A *Hapmyong Hoesa* is organized by two or more partners who bear unlimited liability for the obligations of the partnership. A *Hapmyong Hoesa* is a separate entity subject to corporate income tax.

Yuhan-chekim Hoesa

A *Yuhan-chekim Hoesa* (limited liability company) has characteristics of both a *Yuhan Hoesa* and a *Hapmyong Hoesa*. However, the investors must separately designate employees who will operate the business on the AoI. A Yuhan-chekim Hoesa is a separate entity and subject to corporate income tax.

Hapja Hoesa

A *Hapja Hoesa* consists of one or more partners having unlimited liability and one or more partners having limited liability. Similar to a *Hapmyong Hoesa*, a *Hapja Hoesa* is a separate entity subject to corporate income tax.

Foreign parent company

The foreign investor may directly make a domestic acquisition. Under Korean tax law, dividend and interest payments to a foreign company that does not maintain a permanent

establishment in Korea are subject to withholding tax (WHT). Where the foreign resident country of the investor has a tax treaty with Korea, the WHT may be reduced.

Non-resident intermediate holding company

Capital gains on the disposal of shares in a Korean company by a foreign shareholder company are generally subject to Korean tax, except for certain cases.

Dividends and interest payments made to a foreign company are also generally subject to tax. Since a foreign shareholder residing in a foreign jurisdiction that has a tax treaty with Korea may enjoy the tax treaty benefits, establishing an intermediate holding company in a jurisdiction that has a favorable tax treaty with Korea may be considered. However, to be eligible for tax treaty benefits, the intermediate holding company should meet the anti-treaty shopping provisions (i.e. beneficial owner of the income) under the Korean tax law and the relevant tax treaty.

Joint venture

In most industries, foreign investors may invest without any ownership restrictions. For certain industries, such as newspapers, telecommunications and broadcasters, the Korean government encourages foreign investors to establish joint venture companies with Korean partners rather than wholly owned subsidiaries. In these industries, the government restricts the amount of foreign ownership to a designated percentage.

Choice of acquisition funding

Debt

The investor can use debt and/or equity to fund its investment. Dividend payments are not tax-deductible, but interest expenses can be deducted from taxable income. Expenses incurred in the course of borrowing, such as guarantee fees and bank fees, can also be deducted for tax purposes. Therefore, the investor often prefers to use debt.

Deductibility of interest

In general, interest expenses incurred in connection with a trade or business are deductible for Korean corporate tax purposes. However, certain interest expenses are not deductible, including (among others):

— interest on debt incurred specifically for use in construction projects or for the purchase of fixed assets

— interest on private loans where the source is unknown

— interest payments to unidentifiable recipients

— interest on debt used for the purchase of non-business-related assets

— interest on hybrid instruments, treated as debt in Korea and as equity in the recipient's resident country, in cases where the recipient's resident country does not levy domestic tax for the relevant interest income, effective for fiscal years starting on or after 1 January 2018 (the non-deductible amount of interest is a permanent tax adjustment)

— interest paid to the foreign controlling shareholder that exceeds the lower of the two limits under the thin capitalization rules described below.

First limit: Thin capitalization rules

Under Korea's thin capitalization rules, where a Korean company borrows from its foreign controlling shareholder an amount exceeding two times the equity from the foreign controlled shareholder (six times the equity for financial institutions), interest on the excess portion is not tax-deductible. Money borrowed from a foreign controlling shareholder includes amounts borrowed from an unrelated third party based on guarantees provided by a foreign controlling shareholder. The non-deductible amount of interest is treated as a deemed dividend or other outflow of income, and WHT may apply.

Second limit: 30 percent of adjusted tax EBITDA

In addition to the above threshold, the 2018 revisions to the tax law introduced a second limitation on the deductibility of interest expense from related-party loans, effective for fiscal years starting on or after 1 January 2019. Under the new law, where a domestic company has transaction with a foreign related party, the domestic company may not be able to deduct the net interest expense exceeding 30 percent of the adjusted tax earnings before income tax, depreciation and amortization (EBITDA) (i.e. taxable income + depreciation expense for fixed assets and net interest expense). (The non-deductible amount of interest is treated as other outflow of income.)

Withholding tax on debt and methods to reduce or eliminate it

Where a Korean company pays interest to its foreign lender, the payment is subject to Korean WHT at a rate of 22 percent (15.4 percent for interest on bonds), inclusive of local surtax. This WHT could be reduced where the recipient is a foreign lender resident in a jurisdiction that has an applicable tax treaty with Korea. Other interest payments to foreign lenders may be exempt from WHT where certain conditions are met.

Checklist for debt funding

— Consider whether the use of debt may trigger disallowed interest deductions under the relevant limitation rules and whether the interest rate is an arm's length rate, as required by transfer pricing rules.

— Withholding tax of 22 percent, inclusive of local surtax, applies on interest payments made to a foreign lender that does not have a Korean permanent establishment unless a lower WHT rate is available under the relevant tax treaty.

Equity

An investor may use equity to fund its acquisition.

When capital is injected into a Korean company by an investor, a registration license tax is imposed at a base rate of 0.48 percent (including local surtax) of the par value of the shares issued

on incorporation and of the par value of the shares issued in subsequent capital increases. In certain cases, the applicable capital registration tax rate is three times the normal rate.

Dividends paid to a foreign shareholder that is not considered to have permanent establishment in Korea are not tax-deductible and are subject to WHT at the rate of 22 percent, in the absence of a relevant tax treaty. The actual rate depends on the applicable tax treaty.

Merger

Mergers are allowed in Korea between Korean domestic companies. Usually, a merger may result in various tax implications for the parties involved (i.e. dissolving company, shareholders of the dissolving company or the surviving company). However, where the merger is carefully planned and executed, a substantial part of the merger-related taxes may be mitigated or deferred, especially where the merger is considered to be a 'qualified merger'.

A merger satisfying the following basic conditions is considered a qualified merger for Korean tax purposes:

— Both companies (i.e. surviving and dissolving companies) have engaged in business for at least one year as of the merger date.

— Where consideration is paid, at least 80 percent of the consideration paid to the shareholder of the dissolving company consists solely of shares in the surviving company.

— The surviving company continues to carry out the operations of the transferred business until the end of the fiscal year of the merger.

In the case of a merger, tax loss carry forwards of the surviving company can only be used to offset profits generated from the original business of the surviving company. Similarly, the tax loss carry forwards of the dissolved company can only be used to offset the profits from the business of the dissolved company.

Hybrids

Hybrid instruments are classified either as debt or equity for tax purposes depending on their legal form, rather than their economic substance. Thus, in principle, hybrid instruments, such as profit-sharing loans and interest-free loans, are classified as debt for tax purposes, while redeemable preference shares are classified as equity.

Discounted securities

Securities can be issued at a discount when the nominal interest rate is below the market interest rate. The difference between the nominal price and the issue price may be deducted over the life of the security. However, where the lender is a related party, the interest rate should be based on an arm's length rate to avoid any transfer pricing tax adjustments.

Deferred settlement

Not applicable.

Other considerations

Company law and accounting

The Commercial Law prescribes conditions and procedures related to establishing and liquidating an entity and to M&A-type transactions, such as mergers, split-offs and spin-offs. Where the company fails to comply with the legal and other procedures necessary for such a transaction, the applicable contracts may be considered invalid.

Group relief/consolidation

Group relief/consolidation is available where the controlling company holds 100 percent of the outstanding shares of the subsidiary company and the subsidiary company's head office is located in Korea.

The tax rates for the consolidated group are the same as the corporate income tax rates. Consolidated tax returns must be submitted to the competent tax authority within 4 months of the end of each fiscal year.

Transfer pricing

Under Korean tax law, where the transfer price used between a Korean company and its foreign related party is below or above the arm's length price, the tax authority has the ability to adjust the transfer price and recalculate the resident's taxable income.

The arm's length price should be determined by the most reasonable method in the situation. The taxpayer should disclose the method and reason for adopting it to the tax authorities in a report submitted with the annual tax return.

Dual residency

Not applicable.

Foreign investments of a local target company

Anti-tax haven rules apply where a Korean resident company or individual has invested in a controlled foreign company (CFC) that is located in a tax haven country and has unreasonably retained profits under that country's local generally accepted accounting principles as they pertain to the Korean resident. Where these rules apply, the retained profits are treated as dividends paid to the Korean resident, even where the reserved profits were not actually distributed.

Where the total shares in a CFC that is directly or indirectly held by a Korean resident individual or company and directly held by their family members together account for 10 percent or more of the voting shares in the foreign company, the Korean resident individual or company is subject to the anti-tax haven rules.

These rules are intended to regulate a Korean company that has made abnormal investments in a foreign company that has an average effective income tax rate of 15 percent or less (for both local and foreign income taxes) for the 3 most recent consecutive years.

However, where a company incorporated in a tax haven country actively engages in business operations through an

office, shop or factory that is required for those operations, the anti-tax haven rules do not apply as long as the company has not been engaged in certain listed businesses. Additionally, the above threshold applies only to business years in which a CFC has engaged in those businesses. Thus, the anti-tax haven rules would apply to fiscal years in which the CFC conducted business mainly in:

— wholesale, financial service and insurance, real estate and leasing, professional/scientific and technical services (excluding architectural, engineering and other related services), and business support services, or

— earning passive income arising from owning shares or bonds, providing intellectual rights, renting vessels, aircrafts or equipment, or investment in trust or fund.

If the CFC is a holding company whose main business is to hold and own stocks, the anti-tax haven rules do not apply if the CFC holds at least 40 percent of the shares of its subsidiaries in the same jurisdiction for more than 6 months and 90 percent or more of the CFC's income consists of interest and dividends from subsidiaries in the same jurisdiction.

Comparison of asset and share purchases

Advantages of asset purchases

— The purchase price can be depreciated (amortized) for tax purposes.

— Historical liabilities of the company are not transferred to the new or surviving company.

— No transfer of retained earnings and possible tax liabilities.

— Possible to acquire only part of a business.

Disadvantages of asset purchases

— Benefit of any tax losses incurred by the target company remains with the seller.

— Buyer may be subject to acquisition tax on purchasing applicable assets.

Advantages of share purchases

— Buyer may benefit from tax losses of the target company.

— Buyer may gain the benefit of existing supply or technology contracts.

Disadvantages of share purchases

— Buyer bears secondary tax liability of a target company as a majority shareholder.

— No deduction is available for the purchase price until the disposal of the shares.

— Seller is subject to securities transaction tax.

Korea — Withholding tax rates

This table is based on information available as of 31 December 2017.

The following table contains the withholding tax rates that are applicable to dividend, interest and royalty payments from Korea to non-residents under the tax treaties currently in force. Where, in a particular case, a rate is higher than the domestic rate, the latter is applicable. If the treaty provides for a rate lower than the domestic rate, the reduced treaty rate may be applied at source if the appropriate residence certificate has been presented to the withholding agent making the payment.

However, a withholding agent should obtain pre-clearance from the tax office before applying a treaty to a resident of a country or a region designated by the Ministry of Strategy and Finance (Labuan, Malaysia is currently designated as such). Without the pre-clearance, the withholding agent should apply the domestic withholding tax rates.

An income recipient that claims a reduced tax rate under a tax treaty should submit an application to the income payer before the income is paid.

To identify the exact withholding taxes and calculate the total tax cost of your cross-border transaction, further review should be required.

Source: National Tax Service, Republic of Korea, 2017

Korea

	Dividends		Interest[1] (percent)	Royalties (percent)
	Individuals, companies (percent)	Qualifying companies (percent)		
Domestic rates				
Companies:	20	20	14/20	20
Individuals:	20	N/A	14/20	20
Treaty rates				
Treaty with:				
Albania	10	5[2]	10	10
Algeria	15	5[2]	10	2/10[3]
Australia	15	15	15	15
Austria	15	5[2]	10	2/10[3]
Azerbaijan	7	7	10	5/10[4]
Bahrain	10	5[2]	5	10
Bangladesh	15	10[5]	10	10
Belarus	15	5[2]	10	5
Belgium	15	15	10	10
Brazil	10	10	0/10[6]/15	10/25[7]
Bulgaria	10	5[8]	10	5
Canada	15	5[2]	10	10
Chile	10	5[2]	5/15[6]	5/10[3]
China (People's Rep.)	10	5[2]	10	10
Colombia	10	5[2]	10	10
Croatia	10	5[2]	5	0
Czech Republic	10	5[2]	10	10
Denmark	15	15	15	10/15[9]
Ecuador	10	5[5]	12	5/12[3]
Egypt	15	10[2]	10/15[10]	15
Estonia	10	5[2]	10	5/10[3]
Fiji	15	10[2]	10	10
Finland	15	10[2]	10	10
France	15	10[5]	10	10
Gabon	10	5[2]	10	10
Germany	15	5[2]	10	2/10[3]
Greece	15	5[2]	8	10
Hungary	10	5[2]	0	0
Iceland	15	5[2]	10	10
India	15	15	10	10
Indonesia	15	10[2]	10	15
Iran	10	10	10	10
Ireland	15	10[5]	0	0
Israel	15	5/10[11]	7.5/10[6]	2/5[3]
Italy	15	10[2]	10	10
Japan	15	5[2]	10	10
Jordan	10	10	10	10
Kazakhstan	15	5[5]	10	2/10[3]
Kuwait	5	5	5	15
Kyrgyz	10	5[2]	10	5/10[3]
Laos	10	5[5]	10	5

	Dividends		Interest[1] (percent)	Royalties (percent)
	Individuals, companies (percent)	Qualifying companies (percent)		
Latvia	10	5[2]	10	5/10[3]
Lithuania	10	5[2]	10	5/10[3]
Luxembourg	15	10[5]	5/10[6]	5/10[3]
Malaysia	15	10[2]	15	10/15[12]
Malta	15	5[2]	10	0
Mexico	15	0[5]	5/15[6]	10
Mongolia	5	5	5	10
Morocco	10	5[2]	10	5/10[13]
Myanmar	10	10	10	10/15[4]
Nepal	10	5/10[14]	10	15
Netherlands	15	10[2]	10/15[10]	10/15[13]
New Zealand	15	15	10	10
Nigeria	10	7.5[2]	7.5	7.5
Norway	15	15	15	10/15[13]
Oman	10	5[5]	5	8
Panama	15	5[2]	5	3/10[3]
Pakistan	12.5	10	12.5	10
Papua New Guinea	15	15	10	10
Peru	10	10	15	10/15[4]
Philippines	25	10[2]	10/15[19]	15[20]
Poland	10	5[5]	10	5
Portugal	15	10[2]	15	10
Qatar	10	10	10	5
Romania	10	7[2]	10	7/10[4]
Russia	10	5[15]	0	5
Saudi Arabia	10	5[2]	5	5/10[3]
Singapore	15	10[2]	10	15
Slovak Republic	10	5[2]	10	10
Slovenia	15	5[2]	5	5
South Africa	15	5[2]	10	10
Spain	15	10[2]	10	10
Sri Lanka	15	10[2]	10	10
Sweden	15	10[2]	10/15[10]	10/15[13]
Switzerland	15	5[5]	5/10	5
Thailand	10	10	10/15[6]	5/10/15[16]
Tunisia	15	15	12	15
Turkey	20	15[2]	10/15[10]	10
Ukraine	15	5	5	5
United Arab Emirates	10	5[5]	10	0
United Kingdom	15	5[2]	10	2/10[3]
United States	15	10[17]	12	10/15[18]
Uruguay	15	5	10	10
Uzbekistan	15	5[2]	5	2/5[3]
Venezuela	10	5[5]	5/10[6]	5/10[3]
Vietnam	10	10	10	5/15[4]

Notes:

1 Many of the treaties provide for an exemption or a reduced rate for certain types of interest, e.g. interest paid to public bodies and institutions, banks or financial institutions, or in relation to sales on credit or approved loans. Such exemptions or reductions are not considered in this column.

2 The rate generally applies with respect to participations of at least 25 percent of capital or voting shares/power, as the case may be. In the treaty with Japan, there is a minimum shareholding period of 6 months immediately before the end of the accounting period for which the distribution takes place. In the treaty with Colombia, the lower rates apply if the beneficial owner is a company other than a partnership that holds directly at least 20 percent of the capital of the company paying the dividends.

3 The lower rate applies to royalties for the use of, or the right to use, industrial, commercial or scientific equipment (and information concerning industrial, commercial or scientific experience in the treaty with Luxembourg and Kazakhstan). The protocol to the treaty with Chile includes a most-favored-nation clause, whereby if Chile concludes an agreement with a third OECD member state with a reduced rate, the reduced rate will automatically apply under this tax treaty.

4 The lower rate applies to payments for the use of, or right to use, a patent, trademark, design or model, plan, secret formula or process, or industrial, commercial and scientific equipment or information. In the tax treaty with Peru, the lower rates apply for the payments received as consideration for the furnishing of technical assistance.

5 The rate generally applies with respect to participations of at least 10 percent of capital or voting power, as the case may be.

6 The lower rate applies to payments to a bank, financial institution or insurance company, as the case may be. In the treaty with Brazil, 10 percent of the gross amount of the interest if the recipient is a bank and the loan is granted for a period of at least 7 years in connection with the purchase of industrial equipment or with the study, the purchase and installation of industrial or scientific units, as well as with the financing of public works. In the treaty with Thailand, the lower rate applies to interest paid to a financial institution (including an insurance company), or paid with respect to indebtedness arising as a consequence of a sale on credit of any equipment, merchandise or services, except where the sale was between persons not dealing with each other at arm's length. In the treaties with Chile, Israel, Mexico, Venezuela and Luxembourg, the lower rate applies to interest paid to financial institution (including an insurance company) or paid with respect to indebtedness arising as a consequence of a sale on credit of any equipment, merchandise or services.

7 The higher rate applies to royalties arising from the use or the right to use trademarks.

8 The rate applies to dividends paid to a company (other than a partnership) which holds directly at least 15 percent of the capital of the Korean company.

9 The lower rate applies in the case of industrial investment.

10 The lower rate applies in case of a loan period of longer than 3 years (treaty with Egypt), 2 years (treaty with Turkey) or 7 years (treaty with the Netherlands and Sweden). In the treaty with Sweden, the lower rate applies if the recipient is a bank and the income is connected with a loan term in excess of 7 years.

11 A 5 percent rate applies if a recipient holds at least 10 percent ownership in a paying corporation; however, in such a case, 10 percent applies if the dividends are paid out of profits subject to tax at a lower rate than the normal corporate tax rate in Korea.

12 The 10 percent rate applies to payments for the use of, or the right to use, any patent, knowhow, trademark, design or model, plan, secret formula or process, copyright of any scientific work, or for the use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial or scientific experience; the 15 percent rate applies to payments for the use of, or the right to use any copyright of literary or artistic work including cinematographic films, or tapes for radio or television broadcasting.

13 The lower rate (higher rate in the treaty with the Netherlands, Norway, and Sweden) applies to copyright royalties and other like payments in respect of the production or reproduction of any literary, dramatic, musical or artistic work (but not including royalties in respect of motion picture films and works on film or videotape for use in connection with television).

14 The 5 percent rate applies to dividends paid to a company which holds directly at least 25 percent the shares of the Korean company, and the 10 percent

rate applies to dividends paid directly to a company that holds directly at least 10 percent the shares of the Korean company.

15 The rate applies to dividends paid to a company (other than a partnership) that holds directly at least 30 percent of the capital of the Korean company and invests not less than US$100,000 or the equivalent amount of local currencies in the Korean company.

16 The 5 percent rate applies to payments for the use of or the right to use any copyright or literary, artistic or scientific work, including software, and motion pictures and works on film, tape or other means of reproduction used in radio or television broadcasting; the 10 percent rate applies to payments for the use of or the right to use any patent, trademark, design or model, plan, secret formula or process; the 15 percent rate applies to payments for the use of or the right to use industrial, commercial or scientific equipment or information.

17 The rate applies if equity ownership is at least 10 percent and not more than 25 percent of the gross income of the Korean company for the preceding year consists of interest or dividends.

18 The lower rate applies to royalties for use of copyrighted literature, music, films and TV or radio broadcasts.

19 The lower rate applies to interest paid to public debt or corporate bond that issued by public offering.

20 The amount of tax imposed by the Philippines on the royalties paid by a company, which is a resident of the Philippines, registered with the Board of Investments and engaged in preferred pioneer areas of investment under the investment incentives laws of the Philippines, to a resident of Korea who is the beneficial owner of the royalties, shall not exceed 10 percent of the gross amount of the royalties.

In the case of domestic corporate entities and individuals, an additional 10 percent of surtax is applied. The additional 10 percent of surtax may also be assessed depending on the tax treaty.

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Kuwait

Introduction

Mergers and acquisitions (M&A) are less common in Kuwait than in other Gulf Cooperation Council (GCC) countries. Most expansions into Kuwait by foreign entities are achieved by establishing a limited liability company or through a sponsorship arrangement.

Recent developments

— The tax liability of foreign companies investing in Kuwait for fiscal years starting after 3 February 2008 is set by tax law no. 2 of 2008 at a flat rate of 15 percent on net taxable income. This replaced a range of rates from 0 percent to 55 percent under the Amiri Decree no. 3 of 1955, which applied to fiscal years that started before 3 February 2008.

— Gains derived by a foreign company on the disposal of assets, including conveyance of title to a third party, are taxable under Tax Law no. 2 of 2008 at a rate of 15 percent.

— As of 10 November 2015, the Capital Markets Authority (CMA) has provided that returns (taken to imply dividends) in respect of securities, bonds, financial sukuk (i.e., Sharia-compliant bonds) and similar securities are exempt from income tax (Article 150, Law No. 22 of 2015).

— Further, the Ministry of Finance (MOF) issued a letter clarifying that all profits/returns (as referred to above) made on or after 10 November 2015 are exempt from income tax. Profits/returns made before 10 November 2015 are taxable, even where the resolution of distribution was issued after 9 November 2015. Despite this clarification letter, the implementation of the cut-off date and apportionment of distribution are still uncertain. Given this uncertainty, the above changes were implemented in practice in 2016.

— According to the tax law, tax losses for a financial year can be carried forward for 3 years. Previously, tax losses could be carried forward indefinitely (under the Amiri Decree no. 3 of 1955).

Asset purchase or share purchase

An acquisition may take the form of a purchase of assets or a purchase of shares.

Purchase of assets

For tax purposes, it is necessary to allocate the total consideration given for the purchases of assets. It is advisable for the purchase agreement to specify the allocation of consideration to the acquired assets, based on current market prices. Allocation of purchase consideration is needed both for claiming tax depreciation and determining goodwill.

Goodwill

Amortization of goodwill is not allowed for tax purposes, under the Tax Law no. 2 of 2008 and related circulars.

Depreciation

Depreciation is normally allowed on the cost of assets acquired at rates prescribed under Kuwaiti tax laws. When assets are transferred between related foreign parties, the depreciable cost to the buyer is limited to the allowable cost of the asset to the buyer.

Tax attributes

Under the tax law, the right to adjust or carry forward tax losses is denied in the following cases:

— liquidation of the incorporated body

— change of the legal status of the incorporated body or its expiry

— merger of the incorporated body with another incorporated body.

Value added tax

Currently, value added tax (VAT) is not levied in Kuwait. Based on local media, there are reports that VAT could be introduced in Kuwait during 2019. However, the government has not yet announced a firm date or issued regulations.

Transfer taxes

Stamp duty and stamp duty land tax are not levied in Kuwait.

Purchase of shares

Tax indemnities and warranties

In negotiated acquisitions, it is usual for the buyer to request, and for the seller to provide, indemnities or warranties, as to any of undisclosed tax liabilities of the target. In practice, the Kuwaiti tax authorities do not deem the buyer liable for taxes due from the seller.

Tax losses

The buyer does not derive any potential tax benefit from the target company's pre-acquisition losses because the target's pre-acquisition tax losses cannot be transferred.

Pre-sale dividend

Capital gains earned by a foreign company from mere trading on the Kuwait Stock Exchange (KSE) are exempt.

As noted earlier, dividends on securities listed on the KSE are tax-exempt as of 10 November 2015. These were implemented in practice in 2016.

Cash dividends earned from investment in KSE stocks, directly or through investment trusts and managed funds, were subject to 15 percent tax. A seller may prefer to realize the gain on investment as income by means of a pre-sale dividend. However, since any pre-sale dividend earned by foreign entities is also subject to 15 percent tax, each transaction should be structured according to other considerations.

Tax clearances

While companies incorporated in Kuwait are not subject to corporate income tax, the tax authorities do not issue tax clearance in advance for Kuwaiti companies until all foreign shareholders (if any) of the Kuwaiti company have obtained their respective tax clearance certificates.

Choice of acquisition vehicle

The Companies Law No.1 of 2016, as amended, is relevant when considering a merger or acquisition in Kuwait. Mergers can take place in one of the following ways:

— dissolving one or more companies and transferring the assets and liabilities to another existing company

— dissolving two or more companies and establishing a new company by transferring the assets and liabilities of the dissolved companies to the new company

— dividing the assets and liabilities of a company into two or more parts and merging the parts into existing companies.

In Kuwait, most acquisitions are completed through the purchase of shares in the target company. The consideration given is normally cash, shares or a combination of both.

Local branch

The Companies Law No.1 of 2016, as amended, does not permit foreign companies to establish a registered branch office in Kuwait. Branch operations may be carried out by a foreign entity through the sponsorship arrangement.

Joint venture

Under the Companies Law No.1 of 2016, as amended, foreign entities can carry out business in joint ventures with Kuwaiti entities under the trade license and sponsorship of the venture's Kuwaiti member or in a joint venture with other foreign entities by appointing a Kuwaiti sponsor/agent.

Joint ventures with limited liability companies and Kuwaiti shareholding companies (KSC) require a minimum 51 percent of Kuwaiti shareholding. However, foreign entities are considered subject to income tax based on economic interests held in Kuwaiti entities regardless of the legal shareholding.

Choice of acquisition funding

Interest is a tax-deductible expense under certain circumstances, whereas dividends are not tax-deductible.

There are no thin capitalization rules in Kuwaiti tax law. Interest paid to banks on the purchase of assets generally can be capitalized as part of the asset cost. Interest incurred on share purchases is not allowed as a deductible expense. There are no foreign currency restrictions in Kuwait.

Deductibility of interest

Financial charges paid locally to bank facilities for capital expenditure can be capitalized and added to the cost of the asset. Interest paid to a local bank is deductible where the loan is used for main activities of the company. Interest paid by a foreign entity operating in Kuwait in respect of its current account with its head office is not tax-deductible. Interest paid outside Kuwait would be disallowed unless it can be proved that the funds were used for loans and bank facilities to finance the entity's activities in Kuwait.

Withholding tax on debt and methods to reduce or eliminate it

There is no withholding tax in Kuwait. However, the MOF enforces compliance with the law through Ministerial Order no. 44 of 1985 and article 16,37 and 39 of the Executive Bylaw of Law no. 2 of 2008 ('tax retention regulations'). These regulations require contract owners to retain 5 percent tax from contractors and release it only on the provision of a tax clearance certificate. A treaty may reduce the 15 percent tax rate on the net taxable profits to a lower rate.

Other considerations

Transfer pricing

There are no specific transfer pricing regulations in Kuwait. However, the tax authorities deem certain percentages of the cost of the equipment or services rendered outside Kuwait as inadmissible. The percentage disallowance depends on the nature of relationship between the foreign company and the buyer. Similarly, interest charged by the head office for its current account is not allowable for tax purposes.

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Malaysia

Introduction

Malaysia is a member of the British Commonwealth and its tax system has its roots in the British tax system. During colonial rule, the British introduced taxation to the Federation of Malaya (as it was then known) with Income Tax Ordinance, 1947. The ordinance was repealed by the Income Tax Act, 1967, which took effect on 1 January 1968, and since then, further tax legislation has been introduced.

The current principal direct taxation legislation consists of the following:

— Income Tax Act, 1967 (ITA), which provides for the imposition and collection of income tax.

— Real Property Gains Tax Act, 1976 (RPGT Act), which imposes tax on profits from the disposal of real properties in Malaysia and shares in real property companies (RPC).

— Petroleum (Income Tax) Act, 1967, which imposes tax on profits from petroleum operations.

— Promotion of Investments Act, 1986, which provides for tax incentives for persons engaged in promoted industries or activities.

— Stamp Act, 1949 (Stamp Act), which imposes stamp duty on various instruments.

In Malaysia, the Securities Commission is responsible for implementing guidelines for regulating mergers, acquisitions and takeovers involving public companies. The regulations for the banking and finance sectors are mainly the responsibility of the Central Bank of Malaysia (Bank Negara). Bank Negara is also responsible for currency flows to and from the country. For mergers and acquisitions (M&A) involving parties undertaking manufacturing activities, the approval of the Ministry of International Trade and Industry may be required.

Guidance on government policies and procedures can be obtained from the Malaysian Investment Development Authority (MIDA), which is the government's principal agency for the promotion of the manufacturing and services sectors in Malaysia. MIDA has established a new Incentive Coordination and Collaboration Office with the aim of improving the central coordination of all incentive offerings.

Recent developments

In a move to keep Malaysia competitive, the country has gradually reduced its corporate tax rates from 27 percent in year of assessment (YA) 2007, to 26 percent in YA 2008, 25 percent for YA 2009–2015, and 24 percent for YA 2016 and later years.

In addition, the Malaysian government has implemented a goods and services tax (GST) as of 1 April 2015.

Asset purchase or share purchase

Generally, in the Malaysian context, M&A transactions are undertaken via the acquisition of shares or a business (e.g. asset purchase).

Purchase of assets

Purchase price

Generally, the acquisition price is not deductible (it is a capital cost) except for the cost incurred to acquire qualifying assets in an asset purchase deal (as discussed later in this report).

Goodwill

For tax purposes, the amount of goodwill written off or amortized to the income statement of the company is non-deductible on the grounds that the expense is capital in nature.

Depreciation

The ITA contains provisions for granting initial and annual tax-depreciation allowances on qualifying capital expenditure incurred in acquiring or constructing industrial buildings (as defined) and qualifying plant and machinery used for the

purposes of the taxpayer's business (subject to certain conditions). The main rates of initial and annual allowances are as follows:

Type of allowance	Initial allowance	Annual allowance
Industrial building	10 percent of qualifying expenditure	3 percent of qualifying expenditure
Heavy machinery and motor vehicles	20 percent of qualifying expenditure	20 percent of qualifying expenditure
Plant and machinery (general)	20 percent of qualifying expenditure	14 percent of qualifying expenditure
Office equipment, furniture and fittings and others	20 percent of qualifying expenditure	10 percent of qualifying expenditure

Source: KPMG in Malaysia, 2018

In addition to these allowances, the ITA allows (among other things):

— a tax deduction for capital expenditure on replacement assets that have a life span of 2 years or less and are used for the purposes of the taxpayer's business (e.g. bedding and linen, crockery and glassware, cutlery and cooking utensils, and loose tools)

— a capital allowance equal to the amount of expenditure for small value assets that each cost up to 1,300 Malaysian ringgits (MYR) where the total capital expenditure of such assets generally does not exceed MYR13,000 (the limit of MYR13,000 does not apply to small and medium-sized enterprises)

Separate rates apply to certain capital expenditure in, among others, the plantation, mining, forestry, agriculture and hotel industries.

Balancing allowances or charges may be triggered when a taxpayer disposes of a qualifying capital item (e.g. industrial buildings, plant and machinery).

A balancing allowance arises when the asset's market value or sale price, whichever is higher, is lower than the asset's residual or tax written-down value. A balancing charge arises when the asset's market value or sale price, whichever is higher, exceeds the asset's residual or tax written-down value. However, the amount of balancing charge to be imposed is limited to the amount of capital allowance claimed on the asset before its disposal. Capital allowances claimed on qualifying assets that are disposed of within 2 years may be subject to clawback at the discretion of the Inland Revenue Board (IRB). This typically applies on the disposal of luxury goods.

The provisions on balancing allowances, balancing charges and clawbacks are applicable unless the disposal falls within the ITA's controlled transfer provisions. In a controlled transfer situation, the assets are deemed to transfer at their respective residual values such that no balancing charges or allowances arise.

A controlled transfer situation occurs when:

— the seller of the asset is a person over whom the buyer of the asset has control

— the buyer of the asset is a person over whom the seller of the asset has control

— some other person has control over the seller and the buyer of the asset

— the disposal is effected as a result of a plan of reconstruction or amalgamation of companies

— the disposal is effected by way of a settlement, gifts or devolution of the property in the asset on death.

Tax attributes

The main tax incentives available in Malaysia include pioneer status (an exemption based on statutory income) and investment tax allowance (based on capital expenditure).

These incentives are mutually exclusive and limited to promoted activities or products.

Another form of tax incentive is the reinvestment allowance (RA), which is available to resident companies in the manufacturing and agricultural sectors undertaking expansion, modernization, automation or diversification activities.

Any incentives granted to a company cannot be transferred to the buyer of assets. Thus the buyer in an asset deal may need to apply to the authorities for new incentives, where applicable.

Indirect taxes

In Malaysia, there is an indirect tax framework that consists of the following core taxes and duties:

— service tax (repealed as of 1 April 2015)

— sales tax (repealed as of 1 April 2015)

— import duty

— export duty

— excise duty.

GST, a value added tax, was implemented as of 1 April 2015 to replace service tax and sales tax. GST is levied at 6 percent on the supply of goods and services made in Malaysia in the course or furtherance of a business by a GST-registered person unless such supplies are zero rated, exempted or given relief. GST is also charged on the importation of goods and services.

In a purchase of assets, it is important to determine whether the items purchased (e.g. machinery, equipment or raw materials) are exempt from sales tax (where such items were acquired prior to the implementation of GST), import duty or excise duty. Where there is such

an exemption, the company purchasing the items must officially inform the Royal Malaysian Customs Department of the change in ownership.

For the purchasing company to enjoy the tax/duty exemption on the goods purchased, an application must be made to the Minister of Finance (MOF) to inform the MOF of the transfer of ownership and to obtain approval to extend the tax/duty exemption to the purchasing company.

Where the exemption is granted based on the same grounds as stated previously by the seller company, the company purchasing the goods must adhere to the same conditions attached to the exemption (e.g. the machinery, equipment and raw materials must be used to manufacture the same finished product).

Typically, an asset sale triggers an obligation for the seller to cancel or modify existing indirect tax licenses and for the buyer to apply for new licenses.

The transfer of business that qualifies as a transfer of business as a going concern is treated as neither a supply of goods nor services; no GST is charged by the transferor on the transfer.

Transfer taxes

The stamp duty is imposed on the disposal of property (except stock, shares, marketable securities and accounts receivable or certain book debts) is based on the value of the transaction. For every MYR100 or fraction thereof of the monetary value of the consideration or the market value of the property, whichever is greater, the rates of stamp duty are as follows:

— MYR1 on the first MYR100,000

— MYR2 on amounts over MYR100,000 but not exceeding MYR500,000

— MYR3 on amounts over MYR500,000.

The 2017 budget proposal to increase the upper ad-valorem rate to 4 percent on the value of property in excess of first MY1,000,000, which was to take effect on 1 January 2018, has not been implemented to date.

The rates imposed on other instruments are outlined in the First Schedule of the Stamp Act.

Several kinds of relief are provided in the Stamp Act, including two key reliefs relating to M&A.

Section 15 of the Stamp Act provides relief from stamp duty in connection with a plan for the reconstruction or amalgamation of companies if the following conditions (among others) are met:

— The transferee company must be registered or incorporated in Malaysia or have increased its capital with a view to acquiring the undertaking of, or not less than 90 percent of the issued share capital of, any existing company.

— Not less than 90 percent of the consideration for the acquisition (other than that relating to the transfer to, or discharge by, the transferee company of liabilities of the existing company) consists of:

  — the issue of shares (when an undertaking is to be acquired) in the transferee company to the existing company or to holders of shares in the existing company

  — the issue of shares (when shares are to be acquired) in the transferee company to the holders of shares in the existing company in exchange for the shares held by them in the existing company.

The approval of the collector of stamp duties is required, and anti-avoidance provisions under section 15 may claw back the stamp duty relief (if granted) under certain circumstances.

Section 15A(2) of the Stamp Act provides relief from stamp duty in the case of a transfer of property between associated companies on any instrument if the collector of stamp duties is satisfied that (among other things):

— the effect of the transaction is to transfer a beneficial interest in the property from one company with limited liability to another company and the companies are associated (i.e. one company is the beneficial owner of at least 90 percent of the issued share capital of the other)

— a third company with limited liability is the beneficial owner of not less than 90 percent of the issued share capital of each of the companies.

There are also anti-avoidance provisions in section 15A.

The Stamp Act also empowers the MOF to exempt specific transactions from stamp duty, but this power is rarely exercised.

Purchase of shares

Tax incentives

Tax incentives are granted to companies that undertake promoted activities. A change in ownership of a Malaysian company should not affect the tax incentive it enjoys as long as the company continues to carry out the promoted activity under the tax incentive.

However, there are instances where the Malaysian tax incentive is granted with equity conditions attached, whether directly or indirectly. In these cases, the change in ownership of the company enjoying the incentive may affect the grant of such incentives. As such, it is advisable to ascertain the tax incentives currently enjoyed by the target Malaysian company and any conditions attached to them.

Regulatory issues

Limitations on foreign ownership apply to some extent to a purchase of shares in some restricted industries.

Indirect tax issues

Compared to an asset purchase, indirect tax issues are less significant in the context of a share purchase. However, any historical liabilities that exist remain with the target company despite the change in ownership.

Tax indemnities and warranties

Tax indemnities and warranties are discussed in this chapter's section on tax clearances.

Tax losses

Losses and capital allowances not used in a YA can be carried forward indefinitely, provided the company is not dormant. If the company is dormant, it must satisfy the IRB that more than 50 percent of its shareholders on the last day of the basis period in which the losses or capital allowances arose are the same as on the first day of the basis period in which the unabsorbed losses or capital allowance are to be used.

Unused business losses may be set off against income from any business source. However, unused capital allowances may only be set off against income from the same business source in which the capital allowances arose.

Crystallization of tax charges

The advisors to the prospective buyer may undertake a due diligence review of the books and records of the target company to ascertain the tax position of the target company and identify potential tax liabilities.

Pre-sale dividend

Generally, a company is allowed to pay pre-sale dividends. Dividend payments are discussed later in this report.

Malaysia does not impose withholding tax (WHT) on dividend payments.

Transfer taxes

Transfers of shares in an unlisted Malaysian company attract stamp duty at the rate of 0.3 percent of the value of shares transferred. Based on the guidelines issued by the IRB's Stamp Duty Unit on 21 April 2001, the value of shares transferred for stamp duty purposes is the highest value of the following:

— par value

— net tangible assets

— price-earnings multiple or price-earnings ratio

— actual sale consideration.

The transfer of securities on the Central Depository System does not attract ad valorem stamp duties at 0.3 percent; instead, the contract notes may attract stamp duty at 0.1 percent. However, according to Stamp Duty Remission Order 2003, all contract notes relating to the sale of any shares, stock or marketable securities listed on a stock exchange approved under subsection 8(2) of the Securities Industry Act 1983 are waived from stamp duty exceeding MYR200, calculated at the prescribed rate in item 31 of the First Schedule to the Stamp Act.

Reliefs available for stamp duty and transfer taxes are discussed earlier in this report.

Tax clearances

It is seldom possible to obtain a clearance from the IRB (or from the Royal Malaysian Customs Department) giving assurance that a potential Malaysian target company has no tax arrears without tax or customs audits taking place. Therefore, it is usual to include tax indemnities and warranties in the sale agreement. The extent of the indemnities or warranties is subject to negotiation between the seller and the buyer.

As noted, the advisors to the prospective buyer may undertake a due diligence review of the books and records of the target company to ascertain the tax position of the target company and to identify potential tax liabilities.

Choice of acquisition vehicle

Local holding company

Foreign companies commonly set up Malaysian-resident holding companies to acquire shares or assets in Malaysia. Regardless of where a holding company is incorporated, it is considered a tax-resident in Malaysia if it is managed and controlled in Malaysia. Generally, a company is regarded as being managed and controlled in Malaysia if its directors' meetings are held there.

Historically, Malaysia adopted the imputation system of dividend payments, in which the corporate income tax paid by a company on its profits was fully passed on or imputed to the shareholders when a dividend (other than an exempt dividend) was paid. Therefore, the dividend was paid net of tax but had an imputation tax credit attached. A company receiving taxable dividends from a Malaysian resident company was taxable at the appropriate corporate income tax rate but could claim the tax credit attached to the dividend to offset the resulting tax liability. Thus, one advantage of using a Malaysian resident holding company to hold shares in a Malaysian resident target company was the ability to claim a refund of tax credits when there was sufficient interest cost to offset the taxable dividend income.

As of 1 January 2008, a single-tier system replaced the imputation system. Under the new system, the tax payable by a resident company constitutes a final tax. Dividends paid under the single-tier system are tax-exempt for the shareholders. Transitional provisions allowed the imputation system (with some amendments) to be used until 31 December 2013.

Under the single-tier system, tax relief can no longer be obtained by offsetting interest expense against dividend income because dividends are tax-exempt. Surplus expenses in holding companies, including those listed on Bursa Malaysia, cannot be carried forward.

Issues of interest restriction and allocation can arise when a company has an interest expense and a variety of income-producing and non-income-producing investments. As of 1 January 2009, thin capitalization and transfer pricing provisions have been introduced to the ITA. However, the implementation of the thin capitalization rules was deferred to the end of December 2017 and eliminated as 1 January 2018. Instead, the thin capitalization rules will be replaced by the earning-stripping rules (ESR) advocated by the Organisation for Economic Co-operation and Development (OECD), which are proposed to take effect as of 1 January 2019. Legislation to implement the ESR is not yet released.

Foreign-sourced income received in Malaysia by a resident company (other than a resident company carrying on the business of banking, insurance, shipping or air transport) is exempt from tax. Hence, it may be advantageous to use a Malaysian holding company to hold a foreign investment, as foreign-sourced dividend income (including trading profits from a foreign branch) and gains on the sale of subsidiaries are generally not subject to tax. However, interest costs and other costs attributed to foreign-sourced income incurred by the Malaysian holding company to fund the foreign investment would be wasted.

Non-resident intermediate holding company

Malaysia has concluded agreements for the avoidance of double taxation agreements with an extensive number of countries. (Not all have been ratified, however, and not all are comprehensive).

Local branch

In Malaysia, both a branch and a subsidiary are generally subject to the same tax filing and payment obligations.

Malaysia does not impose branch profits tax on the remittance of branch profits. Therefore, the profits of a local branch may be freely repatriated back to its head office without attracting further tax liabilities in Malaysia.

However, where profits are repatriated in the form of (among other things) royalties, interest or payments for management fees, Malaysian WHT may apply.

Limited liability partnership

The Limited Liability Partnerships (LLP) Act 2012 introduced the concept of an LLP.

For income tax purposes, an LLP is treated as a separate legal entity from its partners. The income of the LLP is taxed at the LLP level. Consequently, the partners are not liable to tax on their share of income from the LLP (whether distributed or not).

Joint venture

A joint venture can be either unincorporated or incorporated. If unincorporated, it needs to be determined whether it is a partnership.

A partnership, other than an LLP, is not taxed as an entity. Instead tax is charged at the partners' level on their share of the adjusted income from the partnership. The divisible income is allocated among the partners according to their profit-sharing formula, and the capital allowances (also allocated according to the profit-sharing formula) are deducted from the partners' chargeable income. If there is a partnership loss, each partner may offset their share of the loss against their income from other sources.

Choice of acquisition funding

The financing of a transaction can be in the form of shares or loan notes, cash, asset swaps or a combination of different types of consideration.

Debt

Where the consideration is in the form of cash, the buyer may have to raise external borrowings, which may involve a variety of regulatory approvals.

Incidental costs of raising loan finance, such as legal, rating and guarantee fees, are viewed as capital costs and so are non-deductible (except for certain Islamic financing and asset-backed securitizations).

Borrowings from a non-resident may require exchange control approval.

Malaysia introduced thin capitalization legislation with effect from 1 January 2009. As noted, the implementation of these rules was deferred to the end of December 2017 and eliminated as 1 January 2018. Instead, they will be replaced by the earning-stripping rules (ESR) advocated by the Organisation for Economic Co-operation and Development (OECD), which are proposed to take effect as of 1 January 2019. Legislation to implement the ESR is not yet released.

Investment in foreign currency assets

Malaysian resident corporations with domestic borrowings that wish to invest in 'foreign currency assets' are required to seek prior approval from Bank Negara for overseas investments through conversion of MYR exceeding MYR50 million per calendar year. The MYR50 million refers to investment abroad by the resident entity and other resident entities within its group of entities with a parent-subsidiary relationship. The threshold for Malaysian-resident individuals is MYR1 million per calendar year.

Malaysian residents with domestic borrowings are free to invest abroad using foreign currency funds, foreign currency borrowings, proceeds from listing shares through an initial

public offering on the Main Market of Bursa Malaysia, or the swapping of financial assets, subject to certain conditions. Malaysian residents with no domestic borrowing are also free to invest abroad.

Foreign currency borrowing and ringgit borrowing

A resident company is allowed to borrow any amount in foreign currency:

— from licensed onshore banks

— from resident and non-resident entities within its group

— from its resident and non-resident direct shareholders

— through the issuance of foreign currency debt securities to another resident.

A resident company may obtain foreign currency credit facilities of up to MYR100 million equivalent in aggregate from other non-residents that are not part of its group of entities. The limit is based on the aggregate borrowing for the group of resident entities with a parent-subsidiary relationship.

A resident company may borrow up to MYR1million in MYR in aggregate from any non-resident, other than a non-resident financial institution, for use in Malaysia. The limit is based on the aggregate borrowing for the group of resident entities with a parent-subsidiary relationship. A resident company is also free to obtain any amount of ringgit borrowing to finance activities in the real sector in Malaysia from a non-resident entity within its group of entities or its non-resident direct shareholder.

Borrowing is defined as any credit facility, financing facility, trade guarantee or guarantee for payment of goods, redeemable preference share, Islamic redeemable preference share, private debt security or Islamic private debt security other than (among others):

— operational leasing facilities

— factoring facilities without recourse

— performance or financial guarantees.

Deductibility of interest

Deductibility of interest costs is governed by sections 33(1) and 33(2) of the ITA. A deduction may be claimed under section 33(1) for an interest expense that is wholly and exclusively incurred in the production of a company's gross income. A company with an ongoing business may deduct the interest expense pursuant to the same section if the expense relates to a loan used for the working capital purposes of the company. An investment holding company may deduct its interest expense against its taxable investment income pursuant to section 33(1).

However, under the single-tier system (discussed earlier), the interest cost incurred by an investment holding company would be lost because the investment income (i.e. dividend income) would be tax-exempt.

The deductibility of the interest expense would also be restricted by section 33(2), when monies borrowed are used directly or indirectly for non-trade purposes (e.g. investments or loans other than for business purposes). This section applies to companies with ongoing businesses that undertake non-business investments. The interest restricted can only be allocated and set off against the taxable income, if any, derived from the non-business investments or loans to which the monies have been applied; the interest expense cannot be set off against business profits. Inefficiencies could arise where these non-trade applications do not produce sufficient taxable income because the restricted interest expense is then lost. For companies with interest expense and non-trade applications, managing interest restriction can be a major issue.

As of YA 2014, a taxpayer is only eligible to deduct interest from money borrowed against its income when such interest is due to be paid. If interest is only accrued in the books of a taxpayer with no stipulated date of payment, interest accrued in that YA is not deductible.

There are also transfer pricing issues to consider (discussed below), as well as the proposed ESR.

Withholding tax on debt and methods to reduce or eliminate WHT

Interest paid or credited to any person who is not tax-resident in Malaysia, other than interest attributable to a business carried on by such person in Malaysia, is generally subject to Malaysian WHT at the rate of 15 percent on the gross amount. A tax treaty between Malaysia and the recipient's country of residence may reduce the rate of WHT. A certificate of residency of the non-resident company must support the reduction. Interest payments to non-resident companies without a place of business in Malaysia in respect of sukuks issued in any currency and debentures issued in MYR, other than convertible loan stocks, approved or authorized by, or lodged with, the Securities Commission or securities issued by the government of Malaysia, are exempt from WHT (the exemption does not apply to interest paid or credited to a company in the same group). ('Sukuks' are certificates of equal value that evidence undivided ownership or investment in assets using Shariah principles and concepts endorsed by the Shariah Advisory Council.)

The following interest paid or credited to a non-resident is also exempt from WHT:

— interest paid or credited to any person in respect of sukuks originating from Malaysia other than convertible loan stock issued in any currency other than MYR and approved or authorized by, or lodged with, the Securities Commission

or approved by the Labuan Financial Services Authority. The exemption does not apply to interest paid or credited to a company in the same group.

— income of a unit trust in respect of interest derived from Malaysia and paid or credited by any bank or financial institution licensed under the Financial Services Act 2013, the Islamic Financial Services Act 2013, or any development financial institution regulated under the Development Financial Institutions Act 2002. The exemption does not apply to a wholesale money market fund that does not comply with criteria set out in the guidelines of the Securities Commission Malaysia.

The tax withheld must be remitted to the IRB within 1 month of the earlier of the paying or crediting of such amount. If not, a penalty of 10 percent of the amount unpaid may be imposed and deduction for the interest expense is disallowed until the penalty and WHT are settled.

As of 1 January 2011, the IRB may impose a penalty for an incorrect return if a tax deduction on interest expense is claimed and the WHT and penalty are not paid by the due date for submission of the tax. Instead of borrowing directly from an offshore location, it may be possible to arrange funding through Labuan. Interest payments by a Labuan company to non-resident are not subject to WHT. Interest payments by one Labuan company to another are also not subject to WHT. However, the exemption may not apply if the other Labuan company makes an irrevocable election to be taxed under the ITA. Exchange control approval may be required.

Checklist for debt funding

Where a Malaysian company is considering debt funding, the following issues should be considered (among others):

— Malaysian WHT on interest paid or credited to a non-resident lender and whether there are ways to minimize or mitigate the impact (as discussed earlier in this report)

— where the debt funding is to be received from a related party, issues relating to the proposed ESR (for which legislation is not yet released), transfer pricing (discussed later in this report) and deductibility of interest (discussed earlier)

— Malaysian exchange controls (discussed earlier).

Equity

Companies must pay registration fees on applying for incorporation to the Registrar of:

— MYR1,000 for a company limited by share

— MYR3,000 for company limited by guarantee

— MYR1,000 for unlimited company.

The registration fee for a foreign company starts at MYR5,000 for share capital of up to MYR1 million and increases gradually to MYR70,000 for share capital above MYR100 million. For foreign companies without share capital, the registration fee is MYR70,000. The registration fee is only deductible for companies having an authorized capital of up to MYR2.5 million on the incorporation date.

For discussion of the tax implications of dividend payments, see 'Local holding company' above.

Hybrids

A commonly used hybrid is the redeemable preference share (RPS), which is usually treated as a form of equity for tax purposes. The use of RPSs allows for flexibility of redemption, which is generally regarded as a repayment of capital (assuming it occurs on a one-off basis).

The RPSs are redeemable if the shares are fully paid up and the redemption shall be out of profits or a fresh issue of shares or capital of the company. When the RPSs are redeemed other than from the proceeds of a fresh issue of shares, a sum equal to the amount of the shares redeemed must be transferred out of profits otherwise available for dividend distribution into the share capital account of the company. The shares can only be redeemed out of capital where:

— all directors have made a solvency statement under Section 113 of Companies Act 2016 in relation to the redemption, and

— the company has lodged a copy of the solvency statement with the Registrar.

The IRB has indicated that RPS distributions generally are not treated as interest for tax purposes.

Discounted securities

Where discounted securities are issued, it must be established whether the discount element is in the nature of interest. If so, refer to the discussions earlier in this report on debt funding.

Deferred settlement

Generally, tax relief under the ITA is claimed when the relevant cost has been incurred, even where the payment is deferred. Generally, Malaysian WHT obligations crystallize on the earlier of paying or crediting a non-resident.

Other considerations

Concerns of the seller

RPGT is a capital gains tax imposed on gains on disposals of real property located in Malaysia or shares in an RPC. An RPC is a company that owns real property in Malaysia or shares in other RPCs to the extent the value of its real property or shares (in other RPCs) or both, is 75 percent or more of the total tangible asset value of the company at the relevant time.

As of 1 January 2014, chargeable gains are taxed at the following rates:

— 30 percent for disposals within 3 years after acquisition

— 20 percent for disposals in the 4th year after acquisition

— 15 percent for disposals in the 5th year after acquisition

— 5 percent for disposals more than 5 years after acquisition

— exempt for disposals by an individual who is a Malaysian citizen or permanent resident more than 5 years after acquisition

— for a seller who is not a Malaysian citizen or permanent resident, the rate of RPGT is 30 percent for disposals within 5 years after acquisition and 5 percent for disposals more than 5 years after acquisition.

Generally, a gain arises when the disposal price exceeds the acquisition price of the real property or the shares in an RPC.

The seller and buyer of a chargeable asset must each make a return to the IRB within 60 days of the date of disposal (as defined) in the prescribed form, supported by the details stipulated in the form. Where the market value of the asset is used, a written valuation by a valuer must be submitted.

The buyer is required to withhold and remit to the IRB the lower of the whole amount of the money received or 3 percent of the total value of the consideration (7 percent of the total value of the consideration if the disposer is not a citizen and not a permanent resident, with effect from 1 January 2018).

Exemptions

Where, with the prior approval of the Director General of the IRB, a chargeable asset is transferred between companies and the transferee company is resident in Malaysia, the transfer is treated as one from which no gain or loss arises in any of these circumstances:

— The asset is transferred between companies in the same group to bring about greater efficiency for a consideration consisting substantially of shares (i.e. at least 75 percent) and the balance in cash.

— The transfer is a result of a plan of reorganization, reconstruction or amalgamation.

— A liquidator of a company distributes the asset and the liquidation of the company was made under a plan of reorganization, reconstruction or amalgamation.

The Director General cannot pre-approve the transfer or distribution of an asset under the last two categories above unless satisfied that the asset is transferred to implement a plan that complies with the government's policy on capital participation in industry. Under these approved transfers, the date of the transferee's acquisition of the chargeable asset is deemed to be the original date of acquisition of the chargeable asset by the transferor. Various anti-avoidance provisions may apply.

The RPGT Act also empowers the MOF to exempt specific transactions from RPGT, but this power is rarely exercised in practice.

Group relief/consolidation

The concept of grouping for tax purposes in Malaysia was originally introduced for selected industries, such as forest plantations and rubber plantations, and selected products in the manufacturing sector, such as biotechnology, nanotechnology, optics and phonics, as well as for certain food products. As of YA 2006, group relief is extended to all other companies.

A company resident and incorporated in Malaysia may now surrender up to 70 percent of its adjusted loss for the basis period to one or more related companies resident and incorporated in Malaysia. To qualify for this treatment, there must be at least 70 percent common ownership through Malaysian companies. There are various restrictions on how tax losses can be transferred; these include definitions of 'group' and a requirement for common year-ends. Companies enjoying certain tax incentives are ineligible.

Transfer pricing

Transfer pricing is an issue of concern to taxpayers in Malaysia in the context of related-party transactions.

In July 2003, the IRB issued formal transfer pricing guidelines, which broadly follow the arm's length principle established under the OECD transfer pricing guidelines. Generally, the OECD and IRB guidelines prescribe that all transactions between associated parties should be on an arm's length basis.

The IRB guidelines cover transactions between:

— associated enterprises within a multinational group where one enterprise is subject to tax in Malaysia and the other enterprise is located overseas

— associated companies within Malaysia.

The scope of the guidelines includes transactions involving lending and borrowing money.

As of 1 January 2009, the Director General of the IRB has been accorded the power (under section 140A of the ITA) to adjust the transfer price of transactions between associated persons when they are of the opinion that the transfer price is not at arm's length. Thus, it is increasingly important that taxpayers can demonstrate that their pricing of goods and services with associated persons is at arm's length.

Taxpayers must ensure that they have sufficient contemporaneous documentation to substantiate the arm's length nature of their transfer prices in accordance with the MOF's Income Tax (Transfer Pricing) Rules 2012.

To enhance certainty on pricing issues for intercompany transactions, the government has introduced an advance pricing arrangement (APA) mechanism. The APA provides a means to predetermine prices of goods and services to be transacted between a company and its associated companies for a specified period. APAs offer considerable security in terms of transfer pricing, although the timeframe to negotiate and conclude the APA should be considered.

For purposes of the APA program, the MOF issued Income Tax (Advance Pricing Arrangement) Rules 2012, along with revised Transfer Pricing Guidelines 2012 (updated in 2017) and Advance Pricing Arrangement Guidelines 2012. As of 1 January 2018, taxpayers are required to pay a non-refundable application fee of MYR5,000 and other charges determined by the Director General of Inland Revenue for an APA application, including renewal.

In order to monitor and tighten compliance with transfer pricing requirements, the corporate tax return form incorporates a new check box for corporate taxpayers to declare whether transfer pricing documentation has been prepared.

Dual residency

Under the ITA, a holding company is considered tax-resident in Malaysia if it is managed and controlled in Malaysia, regardless of where it is incorporated. Generally, a company is regarded as being managed and controlled in Malaysia if its directors' meetings are held there.

It may also be possible that a foreign company may be viewed as a tax-resident in the jurisdiction of its incorporation.

An applicable tax treaty may resolve issues arising due to a company having dual residency.

Foreign investments of a local target company

Generally, Malaysian companies are allowed to undertake foreign investments (bearing in mind the comments in this report in the section on investment in foreign currency assets).

As mentioned above, foreign-sourced income received in Malaysia by a resident company is exempt from tax unless the recipient carries on the business of banking, insurance, shipping or air transport. However, the non-deductibility of costs attributable to foreign-sourced income should be considered.

Tax-neutral reorganizations or mergers

Malaysia does not have a capital gains tax regime except for RPGT, which applies to transactions relating to land and shares in RPCs where such transactions are not subject to the ITA.

For reorganizations or mergers, the Malaysian tax regime allows limited exemptions in the following scenarios:

— Where the transfer of assets for which capital allowances (tax depreciation) have been claimed falls within the ITA's controlled transfer provisions, the assets are deemed to be transferred at their respective tax residual values such that no balancing charges or allowance arises.

— Where the transfer of assets or shares falls within sections 15 or 15A of the Stamp Act and meets the relevant conditions therein, the transaction is relieved from stamp duty.

— The MOF is empowered to exempt specific transactions from stamp duty, but this power is rarely exercised.

— The government may issue specific exemptions from specific taxes (e.g. income tax, stamp duty and RPGT) from time to time by way of statutory orders.

— In relation to RPGT, where, with the prior approval of the Director General of the IRB, a chargeable asset is transferred between companies and the transferee company is resident in Malaysia, the Director General shall treat the transfer as though no gain or loss has arisen in any of these circumstances:

  — the asset is transferred between companies in the same group to bring about greater operational efficiency for a consideration consisting substantially of shares (i.e. not less than 75 percent in shares) and the balance in cash

  — the transfer is a result of a plan of reorganization, reconstruction or amalgamation

  — a liquidator of a company distributes the asset and the liquidation of the company was made under a plan of reorganization, reconstruction or amalgamation.

For transfers under the second and third bulleted items, the scheme concerned must comply with the government's policy on capital participation in industry.

Approval is at the IRB's discretion, and various conditions must be met.

The RPGT act empowers the MOF to exempt specific transactions from RPGT, but this power is rarely exercised.

Comparison of asset and share purchases

Advantage of asset purchases

— The purchase price of qualifying assets (or a proportion) may be depreciated for tax purposes in the form of capital allowances.

— Liabilities and business risks of the seller company are not transferred.

— Possible to acquire only certain parts of a business.

— Interest incurred to fund the acquisition of plant, equipment and other assets that will be used in the trade or business is generally tax-deductible.

— Buyer may claim RA if it has incurred qualifying capital expenditure for the purposes of a qualifying project and has operated in that business for at least 36 months. Where the asset is disposed of within a period of 5 years from the date of purchase of the asset, the RA claimed by the seller is clawed back. Where the assets for which the RA has been claimed are acquired under a controlled transfer in which the transferor has previously claimed RA, the buyer cannot claim RA on the same assets.

— Buyer may be able to claim new incentives, where applicable.

Disadvantages of asset purchases

— Possible clawback of capital allowances claimed by the seller in the form of a balancing charge.

— Clawback of RA, if the qualifying asset is disposed of within 5 years from the date of acquisition.

— Higher stamp duties on the transfer of certain assets.

— Benefits of any losses or unused tax attributes remain in the seller company.

— Benefits of incentives remain in the seller company.

— Possible need to cancel and apply for various indirect tax licenses.

Advantages of share purchases

— No capital allowance or balancing charge clawbacks on seller and no withdrawal of RA.

— Buyer may be able to use and benefit from unused tax attributes and, tax incentives of the target company.

— Lower stamp duties payable on the transfer of shares compared with other physical assets.

— Target company may continue to enjoy tax incentives.

Disadvantages of share purchases

— Buyer may acquire historical tax and other liabilities.

— No deduction or depreciation allowances (capital allowances) are available for the purchase cost of shares.

— No re-basing of underlying assets.

— Buyer may not be able to use the unused tax losses or capital allowances available in the target company where there is a substantial change in shareholders. However, this only applies to dormant companies.

— Deductions for interest incurred to fund the acquisition of shares subject to restriction.

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Oman

Introduction

Oman imposes income tax on broadly the same terms to all types of commercial activity (except petroleum, which is taxed on a different basis at higher rates), regardless of the legal form of the enterprise, or the level of foreign ownership.

There is no zakat imposed on businesses in Oman.

Individuals are only subject to income tax to the extent that they carry on commercial, industrial or professional activities in Oman as a 'proprietorship', in their own name. Otherwise, there is no personal income tax.

Detailed comments on the tax system in Oman are covered under the relevant headings throughout this report.

Overview of Omani income tax law

Income Tax Law No. 28/2009

Income tax is imposed by Income Tax Law No. 28/2009 on the worldwide profits of taxpayers, including dividend income received on foreign shareholdings.

Flat 15 percent income tax rate

The income tax law imposes a flat 15 percent rate of income tax on all domestic and foreign companies and commercial operations.

Credit for foreign tax suffered

The income tax law provides for a tax credit against a company's Omani income tax liability for foreign tax paid on overseas income. The credit is limited to the Omani income tax that would otherwise be due on that income.

Permanent establishment

The definition of 'permanent establishment' (PE) includes a 'services PE' test, which deems a PE to exist where a foreign entity is providing services in Oman through its employees (or other individuals under the control of the enterprise) for a period exceeding 90 days in any 12-month period. This is subject to the application of a tax treaty between Oman and the foreign entity's country of tax residence.

Withholding tax

There are no withholding taxes (WHT) on payments to resident companies. For payments made to non-residents, WHT applies at a standard rate of 10 percent on the gross amount of dividends (paid by joint stock companies only and not limited liability companies), interest, fees for provision of services, royalties, consideration for carrying on research and development, consideration for the use or the right to use computer software, and management fees.

Executive Regulations supplementing income tax law

The income tax law is supplemented by Executive Regulations that took effect on 29 January 2012. Further amendments to these executive regulations are in the pipeline, to address various uncertainties arising from the recent extension of the scope of WHT to dividends, interest and provision of services.

Although the regulations are intended to codify the previous practices of the Secretariat General for Taxation (SGT), the manner in which the regulations are applied and interpreted in certain cases often leads to ambiguities. Until the regulations have been tested through a number of years' tax assessments, there will be some uncertainty over assessments issued by the SGT.

Free Trade Zones and Special Economic Zones

Oman has established free trade zones in Sohar, Salalah and Mazunah and a special economic zone, at Duqm.

The respective zone rules grant exemption from income and other taxes and customs duties for companies, branches and permanent establishments carrying out qualifying projects within the zone. The exemptions are granted on a case to case basis, for terms of 10 to 30 years, depending on the individual zone rules, and the exemption may be extendable. Certain entities or activities may be excluded from qualification.

In addition to the tax exemption, foreign investors are able to hold 100 percent interest in the project vehicle and are exempt from investment restrictions under the Foreign Capital Investment Law (FCIL) and the minimum capital requirements normally imposed under the Commercial Companies Law (CCL).

Recent developments

Recent amendments to the income tax law

For tax years starting after 27 February 2017, taxpayers (including companies registered in Oman), irrespective

of their ownership, are taxable at the rate of 15 percent (increased from 12 percent) on a net basis (i.e. gross revenue less tax-deductible expenses and with no tax-free threshold).

As noted, the scope of WHT has been widened to include withholding tax on dividends, consideration for services and interest payments to non-residents.

As of 27 February 2017, Oman has promulgated a self-assessment regime under which inspection of Final Return of Income (FRI) should occur only on a sample basis. FRI may be assessed by the Oman Tax Authorities within a 3-year period (or returned tax position becomes final). However, the tax authorities usually examine tax returns for 2 or 3 years at once and request additional information and explanations before issuing an assessment (see 'Tax indemnities and warranties' later in this report).

The amended tax law has specific provisions to ensure that Islamic Finance transactions are treated in accordance with their underlying substance for tax purposes, resulting in treatment equivalent to conventional financial transactions.

Future developments

Potential amendments to the Foreign Capital Investment Law

Current proposals to amend the FCIL could remove the requirement for companies to have a local shareholder and permit a foreign investor to hold 100 percent of the shares in an Omani company. There may be a list of certain sectors or activities for which a local shareholder is still required. The amendments may also remove the minimum capital requirements.

Proposed introduction of value added tax

The countries of the Gulf Cooperation Council (GCC) have agreed on a common value added tax (VAT) framework to operate across the GCC states, namely, Oman, Saudi Arabia, Kuwait, Bahrain, Qatar and United Arab Emirates. Each GCC state must formally adopt the agreement and issue its own VAT law, based on the agreed framework.

The Oman government continues to develop its own VAT legislation. Current indications are that the Oman could implement VAT in the first quarter of 2019.

Asset purchase or share purchase

A buyer may acquire a business in Oman by purchasing the trade and assets of the business or by purchasing the shares of the company through which the business is carried on.

As income tax in Oman is applied only to commercial activities, the tax position of the seller is determined by the capacity in which they are selling, that is, as a taxable or non-taxable person.

In the case of a trade and asset sale, the seller would typically be acting in a taxable capacity, either as a company or any other form of commercial entity, or as an individual carrying on business through a proprietorship (each of which is subject to tax).

A sale of shares could be exempt from income tax if the sale is made by an individual holding the shares as an investment (i.e. not holding them in a taxable capacity).

A share sale may also be exempt from tax if the disposal relates to shares in a joint stock company listed on Muscat Securities Market (as opposed to a limited liability company). Any gain on such disposal of listed shares is specifically exempt under the income tax law (discussed in the section on purchase of shares later in this report).

Where a foreign entity has no taxable presence in Oman, it is not subject to Omani income tax, so no Omani income tax should arise on a disposal of shares in an Omani company.

In this commentary, the seller is assumed to be a taxable person. It is helpful for the buyer to be aware of the alternatives and better understand the seller's position.

Purchase of assets

Where the buyer purchases the trade and assets of the business, the seller is subject to income tax on any gain arising on the disposal, consisting the aggregate gain realized on each of the individual assets of the business (and offset by any loss arising on individual loss-making assets).

Capital gains form part of the seller's normal taxable income. Assets on which the seller has claimed tax depreciation are not taxed by way of capital gain but would give rise to balancing allowances or balancing charges, which are themselves reflected in taxable income.

Gains (and losses) are calculated by reference to the proceeds received on disposal. The SGT has broad powers to substitute actual disposal proceeds with fair market value in the case of related-party transactions or transactions considered to have taken place at below market value with a view to avoiding tax.

If a foreign buyer intends to carry on the acquired trade through an Omani branch, the foreign buyer should be aware of the restricted circumstances in which a foreign company can operate through a branch. These restrictions are imposed by the FCIL (discussed below).

Purchase price

The buyer will usually take the purchase price as its tax basis in the assets for its own future capital gains purposes and for purposes of calculating tax depreciation.

The income tax law allows the allocation of sale proceeds across different assets in accordance with the breakdown provided in any sale agreement. The SGT should generally follow this allocation but has the power to apply a different

allocation if it is felt that the contractual allocation is designed to achieve a tax advantage.

Goodwill

The buyer may claim a deduction for goodwill arising on a trade and asset purchase (representing the excess of the purchase price over the fair value of the net assets acquired). The deduction can be claimed over the productive life of the goodwill (or other individual intangible assets). The productive life is determined by the taxpayer but must approved by the SGT on assessment of the buyer's tax return.

Depreciation

A tax deduction is available for depreciation, calculated using the depreciation rates and the depreciation basis specified in the income tax law. The accounting depreciation charge is disregarded for tax purposes.

Tax depreciation is available for capital expenditure incurred in connection with tangible assets (e.g. plant and machinery, vehicles, furniture, computers and buildings) and certain intangible assets (e.g. goodwill, intellectual property rights and computer software). Tax depreciation is not available for the cost of land.

Tax depreciation rates and the basis for depreciation of particular assets are as follows:

Asset Type	Rate	Basis
Tractors, cranes and other heavy equipment and machinery of a similar nature, vehicles, computers, computer software and intellectual property rights, fixtures, fittings and furniture	33 percent on pool of assets	Written-down value or reducing-balance
Digging equipment	10 percent on pool of assets	Written-down value or reducing-balance
All other equipment not included above	15 percent on pool of assets	Written-down value or reducing-balance
Intangible assets — including goodwill but excluding computer software and intellectual property rights (included above)	Productive life of asset as approved by the tax authority	Straight-line
Permanent buildings — superior construction (as determined by the tax authority)	4 percent	Straight-line
Temporary buildings — inferior construction or pre-fabricated	15 percent	Straight-line
Ships and aircraft	15 percent	Straight-line
Quays, jetties, pipelines, roads and railways	10 percent	Straight-line
Hospitals and educational institutions	100 percent	Straight-line

Tax attributes

Tax losses of the acquired business do not transfer to the buyer on a transfer of the trade and assets; tax losses remain with the seller.

Value added tax

There is currently no VAT in Oman, but it is expected to be implemented in the first quarter of 2019 (see 'Future developments').

Transfer taxes

There is currently no stamp duty or other transfer taxes in Oman.

The purchase of land is subject to a registration fee of 5 percent of the agreed land value. There are restrictions on the ownership of land by foreigners.

Purchase of shares

The seller may prefer to dispose of a business by way of share sale where they hold the shares in an individual, non-taxable capacity (see 'Asset purchase or share purchase').

Where the seller is an Omani taxable entity, the disposal of shares in a limited liability company (LLC) is subject to Omani income tax, as is the disposal of an interest in any other form of

commercial enterprise (i.e. proprietorship, share in a general or limited partnership or interest in a joint venture).

The income tax law exempts gains arising on the disposal of shares registered on the Muscat Securities Market, namely joint stock companies taking the form of:

— general Omani joint stock company — with the designation 'SAOG' and representing a public listed company

— closed Omani joint stock company — with the designation 'SAOC' and representing a private listed company.

The main difference between the two forms of joint stock companies is that in a closed joint stock company (SAOC) the transfer of shares is subject to other shareholders' preemptive rights. In an open joint stock company (SAOG), the shares issued may be freely sold to third parties.

A foreign buyer should be aware that the FCIL currently restricts foreign participation in any form of Omani company to 70 percent. This applies whether the shareholding is taken up on incorporation of a new company or acquired on the takeover of an existing company.

Even where the foreign shareholding falls within these limits, the Ministry of Commerce and Industry (MOCI) generally requires the foreign shareholder to show that it has existed for a number of years (typically 3 years) and provide 3 years' audited financial statements in support. In addition, foreign companies with negative equity in their audited accounts would not be permitted to invest in Oman.

A foreign shareholding of more than 70 percent is currently permitted only with the recommendation of the MOCI and approval of the Council of Ministers. Approval is reserved for projects deemed critical to the development of the national economy, such as those involving investment in long-term manufacturing or production facilities, and training and employment of the local labor force. The threshold for approval is typically quite high.

The FCIL sets additional requirements to govern foreign investment, including the minimum share capital that must be invested (see 'Equity' later in this report).

Amendments to the FCIL are being drafted, which — if enacted in their current form — would remove the restriction on foreign share ownership and allow a foreign investor to hold 100 percent of the shares in an Omani company. There may be a list of certain sectors or activities for which a local shareholder is still required. The amendments may also remove or reduce the minimum capital requirements (See 'Future developments').

Under a free trade agreement between Oman and the United States, a US investor can hold an interest in an Omani entity of up to 100 percent without seeking specific approval.

Foreign companies operating in any of the country's free trade or special economic zones are permitted to hold 100 percent of the shares in the registered Omani company through which those activities are carried on, subject to satisfying the requirements set out in the regulations for each zone.

Tax indemnities and warranties

Where the buyer purchases the shares in an existing company, it is usual for the buyer to request, and the seller to provide, indemnities and warranties in respect of undisclosed tax liabilities of the target company. The extent of indemnities and warranties that can be secured is a matter for negotiation.

As the buyer is taking over the target company, together with all related liabilities, the buyer normally requires more extensive indemnities and warranties than in the case of an asset acquisition.

Where significant sums are at stake, it is customary for the buyer to initiate a due diligence exercise, which would normally include a review of the target company's tax affairs.

Omani income tax law currently imposes a full tax assessment system. The SGT considers each tax return that a taxpayer submits for each tax year. The tax assessment period for the SGT to enquire into the tax return has been reduced to 3 years (from 5 years) from the end of the tax year in which the tax return is submitted. Technically, due to a change in tax law, the tax department is required to prescribe a selection process. However, in practice, the tax department is assessing 100 percent of returns, adopting the position that the change in tax law apply only for 2017 and later tax years. As a result, the target company may have more open tax years than in other countries, and older years' assessment enquiries may become more difficult to answer, depending on the availability of information.

Typical indemnities and warranties may impose obligations on the seller to help resolve open tax assessments. As a practical matter, the buyer should consider how this could be enforced over the extended enquiry period in operation in Oman.

Where the target company has a significant number of open tax years, the buyer could consider asking the seller to transfer the trade and assets of the business into a newly incorporated company, so that the buyer can acquire the business in a new, 'clean' company, although this may lead to capital gains tax implications in the hands of the seller on transfer.

In contrast to a share sale, a buyer purchasing the trade and assets of a business does not take over the related liabilities of the company (except for those specifically included in the purchase agreement), and fewer indemnities and warranties may be needed. The indemnities and warranties that can be secured are a matter for negotiation but are also governed by the nature of the individual assets and liabilities being acquired.

Tax losses

A taxpayer can carry forward tax losses for 5 years following the tax year in which the tax loss arose.

On a transfer of the shares in a company, the tax losses remain with the company. The change in ownership does not

restrict the company's ability to carry forward or utilize the tax losses (subject to usual expiry after 5 years).

Crystallization of tax charges

There are no grouping rules in Omani income tax law, so no de-grouping charges would crystallize on the transfer of shares in an Omani company. As a result, the transfer of assets between Omani companies is always taxable.

Where an entity ceases to be taxable in Oman, Omani income tax law may impose exit charges. These provisions deem assets held on the date the taxpayer ceases to be taxable in Oman to have been disposed of at their market value on that date. Any gains (or losses) realized under these provisions are included in taxable income.

Pre-sale dividend

Dividends received from an Omani company are not subject to tax under the income tax law.

If the seller would be subject to income tax on any disposal gain arising on the transfer of shares in the Omani company, they may consider stripping surplus cash out of the company by paying a pre-sale dividend — reducing the purchase price and thus the potential gain on disposal.

Dividends received by an Omani taxpayer from a foreign company are subject to tax. Any such pre-sale dividend would be included in taxable income in the same way as any potential gain on disposal of the foreign shareholding.

Transfer taxes

There is currently no stamp duty or other transfer tax in Oman.

Tax clearances

Any change in the ownership of a company must be reported to the SGT in Oman by filing a revised business declaration form.

Choice of acquisition vehicle

A buyer may use a number of structures to acquire a business in Oman, and the tax and regulatory implications of each can vary. The issues associated with the most common holding structures are discussed below.

Local holding company

Omani income tax law does not provide for the transfer of tax losses between members of the same group or, for example, intra-group transfers of assets at their tax value. Thus, no group relief benefits are gained by holding the shares through a local holding company.

That being said, dividends paid by an Omani company to a local holding company are exempt from income tax. No adverse tax consequences should arise from holding the target company shares in this way, although consideration should be given to the requirements of the CCL in respect of holding companies.

A foreign investor is currently limited to holding a 70 percent shareholding in the Omani company and would need to find a local partner to hold the other 30 percent. A foreign investor looking to acquire a business in Oman may find it beneficial to identify a local partner first and set up a local company that complies with these restrictions. That company could then acquire 100 percent of the shareholding in the target company, allowing the investor to move more quickly once a target is identified.

Potential changes to the FCIL are highlighted in the section on future developments above.

Foreign parent company

Omani income tax law imposes WHT at the rate of 10 percent on dividends paid by a joint stock company to its foreign parent company and other shareholders. Interest paid by all companies to foreign lenders is also subject to WHT.

Omani income tax law does not tax gains realized by an overseas parent company on the disposal of shares in an Omani company (provided the shares are not held through or attributed to a PE in Oman of the parent company).

Management fees and royalty payments paid to the foreign parent company (or other foreign group company) are subject to WHT at 10 percent. Payments for research and development and for the use or right to use computer software are also subject to WHT at the rate of 10 percent. The scope and rate of WHT rate may be reduced by an applicable income tax treaty (see 'Tax treaties' later in this report).

Recent tax law amendments have broadened the scope of domestic WHT (see 'Recent developments').

The income tax law contains broadly drafted provisions governing related-party transactions. Transactions with the foreign parent company (or other foreign group company) must satisfy the arm's length principle. The foreign parent company should make sure that it has appropriate policies governing transactions with the Omani subsidiary and documentation supporting the transfer pricing methodology to mitigate the risk of tax deductions being denied and/ or additional taxable income being imputed in the Omani subsidiary's tax calculation.

Non-resident intermediate holding company

A foreign intermediate holding company is treated in the same way as a foreign parent company. Where the intermediate holding company seeks to claim the benefit of any reduced WHT rates, the SGT would likely take steps to establish whether the intermediate holding company is beneficially entitled to the income, is tax-resident in the treaty country, and includes the income in its own books, before approving the use of the reduced rate.

Local branch

A foreign company can only establish an Omani branch where it is performing a contract awarded to it by the government of Oman. Registration lasts only for the duration of the contract.

Joint venture

A local corporate joint venture (e.g. by way of 50:50 shareholding in an Omani corporate vehicle) is taxed in the same way as a local Omani company. If the corporate joint venture company is formed outside Oman, it would need to meet the requirements to register a local branch (see above) in order to be registered and operate in Oman.

A joint venture formed by way of a joint venture agreement is also treated as a separate taxable entity for Omani income tax purposes. The tax law captures all arrangements that, in substance, represent a pooling of resources and of income and expenses of the joint venture parties. Any joint venture party that is itself subject to income tax in Oman may eliminate its share of joint venture profits from its own income tax calculation such that it is not taxed twice on the share of joint venture profits.

Choice of acquisition funding

Debt

A trade and asset purchase typically gives the buyer more flexibility (than a share acquisition) to introduce debt into the business, and interest paid on debt financing should be deductible (subject to potential restrictions discussed below).

Deductibility of interest

The deductibility of related-party interest is restricted under thin capitalization rules, where the local company has a debt-to-equity ratio in excess of 2:1.

The debt-to-equity analysis takes into account debt from third-party lenders, as well as related-party lenders. Any restriction on the deductibility of interest is applied only to related-party interest payments, and interest on third-party funding is not subject to restriction.

The SGT may also deny some or all of the interest expense on related-party debt where it is felt that the interest rate is not comparable with third-party rates or terms. The related-party lender and the borrower should ensure that they have appropriate policies governing their intragroup loans and documentation supporting the rates and terms in order to mitigate the risk of tax deductions being denied in the local company's tax calculation.

Where the debt is taken by a local holding company (i.e. to acquire the shares in an existing business), the tax deduction for interest paid by the local holding company is denied to the extent that the interest expense relates to exempt income (i.e. dividends from any Omani company or gain on disposal of shares in SAOC or SAOG companies).

Where the local holding company carries on any other taxable activities, the interest expense is apportioned on an appropriate basis and a tax deduction is permitted only for that part that relates to the taxable activity.

Where the foreign company is carrying on its activities through an Omani branch, a tax deduction is denied for any interest expense of the foreign company that is attributed to the branch. In order for interest to be deductible by the branch, any debt should be taken from a third party and in the name of the branch or should be directly identifiable to the branch.

Subject to these restrictions, any income tax deduction would be based on the charge accrued in the financial statements of the company or branch.

No tax deduction is available for fair value adjustments included in the financial statements. A tax deduction is allowed only at the time of payment and the crystallization of any actual gain or loss on the instrument.

Withholding tax on debt and methods to reduce or eliminate it

Omani income tax law imposes WHT at the rate of 10 percent on interest payments.

Checklist for debt funding

— Consider the impact of the thin capitalization rules.

— Where loans are taken from related parties to fund the acquisition, ensure that the rates are comparable to rates that can be obtained from third-party lenders to avoid adjustments by the SGT.

— Where activities are carried on through a branch of the foreign company, consider whether the branch itself can make the borrowing locally, so that interest payments can be deducted against branch income.

Equity

Where a newly incorporated company is used to acquire the trade and assets, the CCL and the FCIL stipulate the minimum equity funding required by each form of company (see 'Purchase of shares' regarding the restriction on foreign investment in an Omani company and cases where the restriction is relaxed; see also 'Future developments').

For an LLC, the current minimum capital requirement is OMR150,000 (approximately 390,000 US dollars — US$). Where a foreign investor is given approval to hold more than 70 percent of the Omani company's share capital, this minimum share capital requirement is increased to OMR500,000 (approximately US$1.3 million). Minimum capital requirements are substantially higher for banks, insurance companies and finance & leasing companies.

These limits apply to an incorporation of a new company as well as a foreign investor's acquisition of shares in an existing Omani company (see the section on choice of acquisition vehicle earlier in this report).

The minimum share capital of an SAOC is OMR500,000 (approximately US$1.3 million). A SAOG is required to have a minimum share capital of OMR2 million (approximately US$5.2 million).

Oman has no capital duty or any other duty or tax on the issue of share capital.

Oman has no exchange controls that limit the repatriation of funds overseas. The following points should be noted when funding a company with equity:

— When a new joint stock company is formed, there is a lock-in period of 2 financial years before promoters can withdraw their money from the company.

— If the target company has accumulated accounting losses, dividends can only be declared once the company has achieved positive distributable reserves.

— In the case of a SAOG, the promoters must have a minimum interest of 30 percent and they are restricted to a maximum interest of 60 percent of the capital, with the remaining shares being offered for public subscription. No single promoter can hold more than 20 percent of the share capital.

Hybrids

Hybrids are not common in Oman.

Discounted securities

Discounted securities are not common in Oman.

Deferred settlement

The income tax law does not set out specific rules governing the taxation of earn-out provisions in sale contracts. The SGT would look at the contract to determine the price at which the sale was completed and, applying general principles, would likely take into account the value of any earn-out rights provided.

The income tax law also gives the SGT broad powers to substitute open market value if it is felt that the transaction has taken place at an undervalue. In principle, this market value substitution should pick up the value of any deferred consideration.

If a final determination of the earn-out value gave rise to a greater amount, the SGT would look to tax this extra amount in the year it was realized. If the earn-out calculation gives rise to a lower amount, it may be difficult to argue for a reduction in the taxable gain. The SGT would likely abide by their earlier determination of open market value.

Where the contract does not provide for an earn-out payment but instead calculates the total sale price at the date of completion and simply defers cash payment, the SGT would calculate the gain based on the consideration stipulated in the sale agreement. The SGT would still consider the open market value position and determine whether any adjustment is needed in calculating the capital gain.

Other considerations

Group relief/consolidation

There is no concept of group tax loss relief under Omani income tax law.

Transfer pricing

The rules governing related-party transactions are drafted very broadly and give the SGT significant scope to challenge what they perceive to be non-arm's length prices.

Increasingly, the SGT requires clear documentary evidence to support positions adopted between related parties. That being said, the income tax law does not currently include specific rules governing the basis on which related-party prices should be calculated — beyond the broad principle that pricing should be on an independent (i.e. arm's length) basis — or any guidance on the form that supporting documentation should take.

The income tax law provides for compensating adjustments to be made in calculating the taxable income of any other taxable Omani related party to the transaction.

The related-party provisions fall within a broader anti-avoidance framework. These rules are also widely drafted and give the SGT broad powers to challenge transactions that they perceive as having avoidance as a motive. The rules also give the SGT powers to make adjustments that they feel necessary to counter the perceived avoidance.

Base Erosion and Profit Shifting Inclusive Framework

Oman has recently joined the Inclusive Framework under the Organisation for Economic Co-operation and Development's Action Plan on Base Erosion and Profit Shifting (BEPS). Oman is the second GCC country after Saudi Arabia to sign the framework. By joining it, Oman has committed to implement the four minimum standards of the BEPS package:

— Measures against harmful tax practices (Action 5).

— Model provisions against treaty abuse (Action 6).

— Transfer pricing documentation and country-by-country (CbyC) reporting (Action 13).

— Enhancing dispute resolution through mutual agreement procedure (Action 14).

Furthermore, members of the Inclusive Framework agree to work together on an equal footing to develop further BEPS measures and commit to participate in peer reviews on BEPS measures' consistent implementation. The implementation of tax treaty related measures to prevent BEPS is covered by the multilateral instrument (Action 15) which has not been signed by Oman yet.

Some of the anticipated key impacts on Oman entities are as follows:

— The Omani tax authorities are expected to increase their focus on substance before providing any treaty benefit to the taxpayer or foreign company.

— Currently, Oman tax law contains provisions in relation to transfer pricing but no documentation requirements. The provisions mention that the transaction prices should be at arm's Length. However, the Omani tax authorities expect the taxpayer to provide detailed transfer pricing documentation during the assessment proceedings. With the increased focus on transfer pricing as part of the BEPS measures, and CbyC reporting as one of the minimum standards, it is likely that explicit documentation requirements may be introduced in Oman.

— Oman will have to work closely with other member countries to monitor implementation of BEPS, which should facilitate access for taxpayers to effective and expedient dispute resolution mechanisms under bilateral tax treaties.

— More detailed disclosures to ensure transparency and additional compliance requirements are expected.

Other International tax considerations

On 5 December 2017, the European Economic and Financial Affairs Council (ECOFIN) determined a list of 17 non-cooperative jurisdictions for tax purposes (i.e. the European Union black list). This list was established based on three screening criteria: tax transparency, fair taxation (no harmful tax regimes) and implementation of BEPS minimum standards.

In addition to the EU black list, there is a separate grey list with 47 jurisdictions that includes Oman. Grey-listed jurisdictions have cause for concern on one or more of the criteria but have committed to address these concerns by changing their tax legislation by the end of 2018 (or the end of 2019 for developing countries). As Oman is not black listed, it does not fall within the recommended sanctions.

Merger provisions in the Commercial Companies Law

The CCL includes provisions for the legal merger of companies in the following ways:

— dissolution of one or more companies and the transfer of assets and liabilities to an existing company

— dissolution of two or more companies and the establishment of a new company to which the assets and liabilities of the dissolved companies are transferred.

The SGT should be notified prior to carrying out a legal merger of companies, and it has the right to object to the merger.

If approved, the SGT should be asked to finalize and close the tax file of the dissolved entity. The tax liabilities of the dissolved entity would transfer to the surviving company.

Further, the surviving company whose ownership has changed on account of merger is required to file a revised business declaration form with the SGT.

Foreign Capital Investment Law

In addition to the foreign ownership restrictions detailed in earlier sections, a foreign national or entity must obtain a license from the MOCI before engaging in any commercial, industrial or tourism business in Oman or acquiring an interest in the capital of an Omani company.

The license is granted on certain conditions, including that the business be carried on through an Omani company.

Foreign companies may operate in Oman through a branch only by virtue of a special contract or agreement with the government or in the case of projects declared by the cabinet as necessary for the country. A branch registration is valid only for the duration of the project.

In the case of a takeover of an Omani branch of another foreign company (or an acquisition of the shares in the foreign company owning the Omani branch), the buyer should satisfy itself that the branch registration continues to be an appropriate form for operating in Oman. The change in ownership would need to be reported to the MOCI.

Although the FCIL restricts the level of investment by foreign entities in an Omani company, the law protects the foreign investor by:

— ensuring the right of foreign investors to repatriate capital and profit

— stipulating that foreign investment projects may not be confiscated or expropriated unless it is in the public interest (in which case equitable compensation must be paid)

— requiring the use of a local or international arbitration tribunal (as may be agreed) in the case of disputes between the foreign investor and third parties.

See comments regarding proposed changes to the FCIL in 'Future developments' above.

Labor law and Omanization

The government of Oman has set targets in certain sectors for Omanization (employment of Omani nationals). All companies must adhere to these targets.

The government also has in place a wage protection system that requires all salary amounts to be paid to local employees through a local bank account.

Other approvals/consents

In addition to the requirements of the CCL and the FCIL, public companies and regulated industries, including banking and insurance companies, require the approval of the relevant regulating agency.

For all M&As, consideration should be given to informing and, where necessary, obtaining the consent of key customers and suppliers (particularly in the case of government contracts).

Foreign exchange controls

There are no foreign exchange controls in Oman. Capital and income may be repatriated without restriction.

Foreign investments of a local target company

The income tax law adopts a worldwide basis of taxation and, in particular, taxes foreign dividends (and other foreign source income) received by an Omani taxpayer.

A tax credit is available for any foreign tax paid. The tax credit is restricted to the amount of the Omani income tax liability relating to that particular item of foreign income.

In carrying out a due diligence review of an Omani target company, the buyer should consider the company's related-party transactions with its foreign subsidiaries and whether any challenge of those transactions under the related-party provisions of Omani income tax law could trigger additional tax for the Omani target company.

The SGT requires strong documentary evidence to support the pricing of related-party transactions, and the outcome of their assessments cannot be predicted reliably.

Comparison of asset and share purchases

Advantages of asset purchases

— Buyer is entitled to depreciation on the fair value of assets purchased and would take a fair value tax basis for capital gains purposes.

— Seller's tax history and tax liabilities do not transfer to the buyer.

— A deduction can be claimed against any goodwill included in the acquisition.

— Buyer is able to choose which assets and which parts of the business to acquire and does not need to acquire unwanted parts of the business.

— Buyer may have greater flexibility to fund the acquisition with debt and achieve the preferred debt-equity mix.

Disadvantages of asset purchases

— Pre-acquisition losses do not transfer to the buyer and are not available for use by the acquiring company.

— The company selling the assets is liable to tax on any capital gains arising from sale of the business assets (including goodwill). This may be unattractive to the seller, who may look to increase the sale price accordingly.

Advantages of share purchases

— Pre-acquisition tax losses within the target company are acquired and can be carried forward to be offset against future taxable income of the target company (subject to 5-year expiry of unused tax losses).

— Seller may be exempt from tax on any gain arising on a share disposal where the shares qualify for exemption (companies with SAOC or SAOG status) or where the individual is not holding the shares in a taxable capacity.

Disadvantages of share purchases

— Buyer inherits the tax history of the target company and any tax liabilities that might arise in connection with open tax years. Suitable warranties and indemnities should be included in the sale agreement and — more importantly — they should be enforceable if liabilities should arise.

— No tax deduction is available against goodwill realized on the acquisition of shares.

— It may be more difficult to adjust the debt-to-equity balance of the target company.

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Philippines

Introduction

In recent years, corporate acquisitions, business reorganizations, combinations and mergers have become more common in the Philippines. Corporate acquisitions can be effected through a variety of methods and techniques, and the structure of a deal can have material tax consequences. Although reorganizations are generally taxable transactions, tax-efficient strategies and structures are available to the acquiring entity.

Recent developments

Republic Act 10963

On 19 December 2017, Republic Act No. 10963, also known as the Tax Reform for Acceleration and Inclusion (TRAIN) bill, was signed into law, and the bill took effect on 1 January 2018. The TRAIN law affects merger and acquisition (M&A) transactions in the areas of donor's tax, value added tax (VAT) and stamp duty (or documentary stamp tax) as discussed below.

Republic Act 10667

In 2015, one major law was enacted affecting M&A in the Philippines. Republic Act No. 10667, also known as the Philippine Competition Act, was signed into law on 21 July 2015. It provides for the creation of an independent, quasi-judicial body called the Philippine Competition Commission.

The law grants the commission the power to review M&As based on factors the commission deems relevant. M&A agreements that substantially prevent, restrict or lessen competition in the relevant market or in the market for goods or services, as the commission may determine, are prohibited, subject to certain exemptions.

Parties to a merger or acquisition agreement with a transaction value exceeding 1 billion Philippine pesos (PHP) are barred from entering their agreement until 30 days after providing notification to the commission in the form and containing the information specified in the commission's regulations. An agreement entered in violation of this notification requirement would be considered void and subject the parties to an administrative fine of 1–5 percent of the transaction's value.

The law also provides that the commission shall promulgate other criteria, such as increased market share in the relevant market in excess of minimum thresholds, which may be applied specifically to a sector or across some or all sectors in determining whether parties to a merger or acquisition should notify the commission.

If the commission determines that such agreement is prohibited and does not qualify for exemption, the commission may:

— prohibit the agreement's implementation

— prohibit the agreement's implementation until changes specified by the commission are made

— prohibit the agreement's implementation unless and until the relevant party or parties enter into legally enforceable agreements specified by the commission.

The Commission published Memorandum Circulars (MC) Nos. 16-001 and 16-002 on 22 February 2016, and they will take effect on 8 March 2016. MC 16-001 provides transitional rules for M&As executed and implemented after the effective date of the Philippine Competition Law and before the effective date of its Implementing Rules and Regulations (IRR). Similarly, MC 16-002 provides transitional rules for M&As of companies listed with the Philippine Stock Exchange.

Application for tax treaty relief

On 28 March 2017, the Bureau of Internal Revenue (BIR) issued Revenue Memorandum Order (RMO) No. 08-2017 effective 26 June 2017 regarding the procedures for claiming tax treaty benefits for dividend, interest and royalty income of non-resident income earners. The RMO dispensed with the mandatory tax treaty relief application (TTRA) for dividends, interests and royalties. Instead, preferential treaty rates for dividends, interests and royalties may now be applied by Philippine withholding tax agents on submission of a Certificate of Residence for Tax Treaty Relief (CORTT) Form.

RMO No. 08-2017 does not apply to other types of income such as business profits and gains from alienation of property. In these cases, RMO No. 72-2010, as discussed below, applies and obtaining a ruling is still required.

On 25 August 2010, the BIR issued RMO No. 72-2010, which mandates the filing of a TTRA for entitlement to preferred tax treaty rates or exemptions. Under current regulations, this is now limited to income other than dividends, interests and royalties as covered by RMO No. 08-2017. The TTRA must be filed before the occurrence of the first taxable event (i.e. the activity that triggers the imposition of the tax).

The BIR relaxed the TTRA filing deadline after a Philippine Supreme Court ruling in August 2013. In that case, the BIR denied a TTRA because the taxpayer failed to file their TTRAs before the occurrence of the first taxable event. The court held that the obligation to comply with a tax treaty takes precedence over a BIR revenue memorandum.

Asset purchase or share purchase

An acquisition in the Philippines may be achieved through a purchase of a target's shares, assets or entire business (assets and liabilities). Share acquisitions have become more common, but acquisitions of assets only still occur. A brief discussion of each acquisition method follows.

Purchase of assets

Income from an asset acquisition is taxed in the Philippines where the transfer of title or ownership takes place in the Philippines. This is an important consideration for planning and structuring an asset acquisition. Generally, the value of an asset is its selling price at the time of acquisition. For purposes of determining gain or loss, the gain is the amount realized from the sale over the asset's historical or acquisition cost or, for a depreciable asset, its net book value.

Purchase price

To help avoid questions from the tax authorities on the valuation of an asset, the selling price should be at least equivalent to the book value or fair market value (FMV) of the asset, whichever is higher. In a purchase of assets in a business, it is advisable that each asset be allocated a specific purchase price in the purchase agreement, or the tax authorities might arbitrarily make a specific allocation for the purchase price of those assets. In addition, in an acquisition of assets, a sale comes within the purview of the Bulk Sales Law if it is a sale of all or substantially all of the trade or business or of the fixtures and equipment used in the business. The seller must comply with certain regulatory requirements; if not, the sale is considered fraudulent and void.

Goodwill

Goodwill is not subject to depreciation. The tax authorities have consistently held that no amount of goodwill paid may be deducted or amortized for tax purposes unless the same business or the assets related to the goodwill are sold. Thus, for tax purposes, since goodwill is not deductible or recoverable over time in the form of depreciation or amortization allowances, the taxpayer can only recover goodwill on a disposal of the asset, or a part of it, to which the goodwill attaches. In this case, the gain or loss is determined by comparing the sale price with the cost or other basis of the assets, including goodwill.

In the sale of a business or asset, payment for goodwill is normally included as part of the purchase price without identifying the portion of the purchase price allocated to it. Therefore, goodwill could form part of the purchase price for purposes of determining gain or loss from the subsequent sale of the business or assets, or for depreciation of depreciable assets.

Intangibles, such as patents, copyrights and franchises used in a trade or business for a limited duration, may be subject to a depreciation allowance. Intangibles used in a business or trade for an unlimited duration are not subject to depreciation. However, an intangible asset acquired through capital outlay that is known, from experience, to be of value to the business for only a limited period may be depreciated over that period.

On the sale of a business, a non-competition payment is a capital expenditure that may be amortized over the period mentioned in the agreement, provided the non-competition is for a definite and limited term. Any loss incurred on the sale may be claimed as a deduction from gross income, except for capital losses, which can only be used to offset capital gains.

Depreciation

Depreciation allowances for assets used in trade and business are allowed as tax deductions. Any method, such as straight-line, declining-balance, sum-of-the-years' digit and rate of depreciation, may be adopted as long as the method is reasonable and has due regard to the operating conditions under which it was chosen.

An asset purchase does not generally affect the depreciation. Usually, the buyer revalues the life of the asset purchased for the purposes of claiming the tax-deductible allowance.

Tax attributes

An acquisition of assets may be structured tax-free (non-recognition of gain or loss) when property is transferred to a corporation in exchange for stock or units of participation, resulting in the transferor, alone or with no more than four others, gaining control (at least 51 percent of voting power) of the corporation. However, if money or other property (boot) is received along with the shares in the exchange, any gain is recognized up to the value of the boot and FMV of other property where the transferor does not distribute the boot. Gains should also be recognized if, in the exchange, a party assumes liabilities in excess of the cost of assets transferred. Losses cannot be deducted.

The provisions for tax-free exchanges merely defer the recognition of gain or loss. In any event, the original or historical cost of the properties or shares is used to determine gain or loss in subsequent transfers of these properties.

In later transfers, the cost basis of the shares received in a tax-free exchange is the same as the original acquisition cost or adjusted cost basis to the transferor of the property exchanged. Similarly, the cost basis to the transferee of the property exchanged for the shares is the same as it would be to the transferor.

The formula for determining substituted basis is provided in BIR Revenue Memorandum Ruling No. 2-2002. 'Substituted basis' is defined as the value of the property to the transferee after its transfer and the shares received by the transferor

from the transferee. The substituted bases of the shares or property are important in determining the tax base to be used in a tax-free exchange when calculating any gain or loss on later transfers.

Value added tax

In asset acquisitions, a 12 percent VAT is imposed on the gross selling price of the assets purchased in the ordinary course of business or of assets originally intended for use in the ordinary course of business.

The TRAIN law amended the enumeration of VAT-exempt transactions, expressly providing that transfers of property pursuant to Section 40 (C)(2) of the Tax Code (such as mergers and tax-free exchanges) are VAT exempt.

Transfer taxes

An ordinary taxable acquisition of real property assets is subject to stamp duty. In tax-free exchanges, no stamp duty is due on the deed transferring the property. However, the shares of stock issued in exchange for the property is subject to stamp duty if they are an original issue of shares. Under the TRAIN law, as of 1 January 2018, the stamp duty on original issue of shares to PHP2 (from PHP1) on each PHP200, or part thereof, of the par value of the shares. All transfers of personal property are exempt from stamp duty.

Purchase of shares

The shares of a target Philippine company may be acquired through a direct purchase. Gains from the sale are considered Philippine-source income and are thus taxable in the Philippines regardless of the place of sale. Capital gains tax (CGT) is imposed on both domestic and foreign sellers. Net capital gain is the difference between the selling price and the FMV of the shares, whichever is higher, less the shares' cost basis, plus any selling expenses. In determining the shares' FMV, the adjusted net asset method is used whereby all assets and liabilities are adjusted to FMVs. The net of adjusted asset minus the liability values is the indicated value of the equity. The appraised value of real property at the time of sale is the higher of:

— FMV as determined by the Commissioner of Internal Revenue

— FMV as shown in the schedule of values fixed by the provincial and city assessors

— FMV as determined by an independent appraiser.

Accordingly, for CGT purposes, it is advisable that the selling price not be lower than the FMV. Capital gains are usually taxed at:

— for sales of unlisted shares: 5 percent for amounts up to PHP100,000, and 10 percent for amounts over PHP100,000

— for sales of publicly listed/traded shares: six-tenths of 1 percent of the gross selling price or gross value in money.

A capital loss from a sale of shares is allowed as a tax deduction only to the extent of the gains from other sales. In other words, capital losses may only be deducted from capital gains.

Most acquisitions are made for a consideration that is readily determined and specified, so for share purchases, it is imperative that shares not be issued for a consideration less than the par or issued price.

Consideration other than cash is valued subject to the approval of the Philippine Securities and Exchange Commission (SEC).

Tax indemnities and warranties

When the transaction is a share acquisition, the buyer acquires the entire business of the company, including existing and contingent liabilities. It is best practice to conduct a due diligence review of the target business. A due diligence review report generally covers:

— any significant undisclosed tax liability of the target that could significantly affect the acquiring company's decision

— the target's degree of compliance with tax regulations, status of tax filings and associated payment obligations

— the material tax issues arising in the target and the technical correctness of the tax treatment adopted for significant transactions.

Following the results of the due diligence review, the parties execute an agreement containing the indemnities and warranties for the protection of the buyer. As an alternative, it is possible to spin-off the target business into a new company, thereby limiting the liabilities to those of the target.

Tax losses

The change in control or ownership of a corporation following the purchase of its shares has no effect on any net operating loss (NOL) of the company. The NOL that was not offset previously as a deduction from gross income of the business or enterprise for any taxable year immediately preceding the taxable year in question is carried over as a deduction from gross income for the 3 years immediately following the year of such loss. The NOL is allowed as a deduction from the gross income of the same taxpayer that sustained and accumulated the NOL, regardless of any change in ownership. Thus, a purchase of shares of the target corporation should not prevent the corporation from offsetting its NOL against its income.

Crystallization of tax charges

As a share acquisition is a purchase of the entire business, any and all tax charges are assumed by the buyer. This is one of the areas covered by the indemnities from the seller, for which a hold-harmless agreement is usually drawn up.

Pre-sale dividend

While not a common practice, dividends may be issued prior to a share purchase. However, dividends are subject to tax, except for stock dividends received by a Philippine company from another Philippine company.

Transfer taxes

Transfers of shares of stock, whether taxable or as part of a tax-free exchange, are subject to stamp duty. Only sales of shares listed and traded on the Philippine stock exchange are exempt from stamp duty. As of 20 March 2009, the Republic Act 9648 permanently exempts such sales from stamp duty.

Choice of acquisition vehicle

In structuring an acquisition or reorganization, an acquiring entity or investor can use one of the entities described below. Since the tax implications for different income streams vary from one acquisition vehicle to another, it is best to examine each option in the context of the circumstances of each transaction.

Local holding company

A Philippine holding company may be used to hold the shares of a local target company directly. The main advantage of this structure is that dividends from the target company to the holding company are exempt from tax. Although distributing the dividends further upstream to the foreign parent company will attract the dividend tax, tax-efficiency may still be achieved through the use of jurisdictions where such foreign parent company is located. It is common to use a jurisdiction with which the Philippines has an effective tax treaty to optimize tax benefits.

One disadvantage of a Philippine holding company is that it attracts an improperly accumulated earnings tax (IAET). Under current law, the fact that a corporation is a mere holding company or investment company is prima facie evidence of a purpose to avoid the tax on the part of its shareholders or members. Thus, if the earnings of the Philippine holding company are allowed to accumulate beyond the reasonable needs of the business, the holding company may be subject to the 10 percent IAET.

Foreign parent company

Where a foreign company opts to hold Philippine assets or shares directly, it is taxed as a non-resident foreign corporation. A final withholding tax (WHT) of 15 percent is imposed on the cash or property dividends it receives from a Philippine corporation, provided the country in which the non-resident corporation is domiciled allows a credit against the tax due from the non-resident corporation taxes deemed paid in the Philippines equivalent to 15 percent. This is referred to as the tax sparing provision under the Tax Code. In this case, a provision under the Tax Code, and not a tax treaty, provides for the preferential tax rate on dividends.

Similarly, the tax rate for dividends, interests and royalties may be reduced where a tax treaty applies without the need for a confirmatory ruling under RMO No. 08-2017. As noted earlier, preferential rates and exemptions for income other than dividends, interest and royalties under a treaty are allowed only if a prior ruling has been secured.

Philippine corporation law does not permit a foreign company to merge with a Philippine company under Philippine jurisdiction. However, they may elect to merge abroad.

Non-resident intermediate holding company

Certain tax treaties provide exemption from CGT on the disposal of Philippine shares. Gains from sales of Philippine shares owned by a resident of a treaty country are exempt from CGT, provided the assets of the Philippine company whose shares are being sold do not consist principally (more than 50 percent) of real property interests in the Philippines. Also, some treaties (e.g. Philippines-Netherlands tax treaty) grant a full exemption on alienation of shares without condition (i.e. without the real property interest component). This is a potential area for planning, and specific treaties should be consulted.

Local branch

In certain cases, foreign companies may opt to hold Philippine assets or shares through a branch office. As with a domestic corporation, the Philippine-source income of a resident foreign corporation, such as a branch, is taxed at the rate of 30 percent (from 1 January 2009). Through the attribution principle implemented under Revenue Audit Memorandum Order No. 1-95, a portion of the income derived from Philippine sources by the foreign head office of the branch is attributed to the branch, following the formula in the order. The income is apportioned through the branch or liaison office that was not party to the transaction that generated the income. The branch or liaison office then becomes liable to pay tax on the income attributed to it. Profit remitted to a foreign head office is subject to a 15 percent WHT, unless reduced by a tax treaty.

In establishing a branch office in the Philippines, the SEC requires that the foreign head office comply with certain financial ratios (i.e. 3:1 debt-to-equity ratio, 1:1 solvency ratio and 1:1 currency ratio).

Joint venture

Joint ventures may be either incorporated (registered with the SEC as a corporation) or unincorporated. Both forms are subject to the same tax as ordinary corporations. Unincorporated joint ventures formed to undertake construction projects, or those engaged in petroleum, coal, geothermal or other energy operations under a government service contract, are not taxable entities. Profits distributed by the joint venture or consortium members are taxable.

Choice of acquisition funding

Corporate acquisitions may be funded through equity, debt or a combination of the two.

Debt

Companies tend to favor debt over equity as a form of financing mainly because of the tax-favored treatment of interest payments vis-à-vis dividends (see this report's

information on deductibility of interest). The tax advantage of interest payments, in contrast to dividends, is an outright savings of 30 percent in the form of deductible expense against the taxable base. Since interest payments are subject to a 20 percent final tax under the Tax Code, financing through debt still has an advantage over financing with equity equivalent to 15 percent.

Currently, there are no specific rules for determining what constitutes excessively thin capitalization, so a reasonable ratio of debt to equity must be determined case-by-case.

Deductibility of interest

Under current law, interest payments incurred in a business are deductible against gross income. The allowable deduction for interest expense is reduced by 33 percent of the company's interest income, if any, subjected to final tax.

Withholding tax on debt and methods to reduce or eliminate it

Generally, interest income received by a Philippine corporation from another Philippine corporation is subject to the regular corporate income tax of 30 percent. However, interest income received by a non-resident foreign corporation from the Philippines is subject to a final withholding tax of 20 percent. The rate of WHT may be reduced under a tax treaty with no need for a confirmatory ruling under RMO No. 08-2017.

Checklist for debt funding

As no specific rules determine what constitutes excessively thin capitalization, a reasonable ratio of debt-to-equity should be determined case-by-case.

Equity

A buyer may use equity to fund its acquisition by issuing shares to the seller as consideration.

A tax-free acquisition of shares can be accomplished through a share-for-share exchange between the acquiring company and the target company. In such an exchange, one party transfers either its own shares or the shares it owns in a domestic corporation solely in exchange for shares of stock in the other company, and the transferor gains control of the transferee company. In the same manner, the transferee company becomes the controlling stockholder of the transferor company since the shares received are the domestic shares of the transferee company.

This is considered a tax-free exchange within the scope of Section 40(C)(2) of the Tax Code. No gain or loss is recognized if property (including shares of stock) is transferred to a corporation by a person in exchange for stock or units of participation in such a corporation such that the person, alone or with no more than four others, gains control (stock ownership of at least 51 percent of the total voting power) of the corporation.

Hybrids

The current laws contain no guidelines on whether to classify hybrid financial instruments as equity infusions or debt instruments. The question is whether a loan is a bona fide loan or a disguised infusion of capital.

If it is the latter, there is a risk that the BIR may:

— disallow the interest expense

— where the loan is carries an interest rate that is less than the prevailing market rate, impute interest income to the lender and assess additional income tax thereon.

Certain court decisions may provide some guidance on whether a transaction should be considered a bona fide loan or a dividend distribution. To date, no authoritative or definitive rulings have been issued.

Discounted securities

Under Philippine laws, the discount on discounted securities is treated as interest income rather than a taxable gain. For discounted instruments, a trading gain arises only where the instrument is sold above par.

Other considerations

Concerns of the seller

In an acquisition of assets, a sale comes within the purview of the Bulk Sales Law where it is a sale of all or substantially all of the trade or business, or of the fixtures and equipment used in the business. The seller must comply with certain regulatory requirements; if not, the sale is considered fraudulent and void.

VAT applies to sales of goods in the ordinary course of trade or business (i.e. the regular conduct or pursuit of a commercial or an economic activity, including incidental transactions). Thus, isolated transactions generally are not subject to VAT.

However, decisions of the Philippine Court of Tax Appeals in 2013 consistently hold that an isolated transaction may be considered an incidental business transaction for VAT purposes. Hence, VAT may be imposed on isolated transactions such as sales of assets, shares or the whole business enterprise.

Company law and accounting

The Corporation Code of the Philippines governs the formation, organization and regulation of private companies, unless they are owned or controlled by the government or its agencies. The Corporation Code also governs mergers and other business combinations.

The Corporation Code allows two or more corporations to merge into either of the constituent corporations or a new consolidated corporation. Under the Philippine Tax Code, the terms 'merger' and 'consolidation' are understood to mean:

— an ordinary merger or consolidation

— the acquisition by one corporation of all or substantially all the properties of another corporation solely for stock, undertaken for a bona fide business purpose and not solely for the purpose of escaping the burden of taxation.

Mergers in the Philippines require a transfer of all the assets and liabilities of the absorbed corporation to the surviving corporation. This step is followed by the dissolution of the absorbed corporation. In return for the transfer of all the assets and liabilities of the absorbed corporation, the surviving entity issues a block of shares equal to the net asset value transferred. These shares are in turn distributed to the stockholders of the absorbed corporation.

A de facto merger is the acquisition by one corporation of all or substantially all of the properties of another corporation solely for stock, usually undertaken for a bona fide business purpose and not solely to escape taxation. For the acquisition to be considered substantial, at least 80 percent of the assets acquired must have an element of permanence; that is, not acquired for immediate disposal. Unlike a statutory merger, where the absorbed corporation is automatically dissolved as a consequence of the merger, in a de facto merger, the corporation the assets of which were acquired survives after the transfer until it is later dissolved by another act.

The tax consequences of a de facto merger are similar to those of a statutory merger. However, in a de facto merger, the acquisition of assets does not automatically result in the dissolution of the corporation the assets of which are acquired, and so the net operating loss carryover (NOLCO) of the absorbed corporation is not transferred to the acquiring corporation.

A legitimate business purpose for the merger is essential. Without it, the merger could be treated as a mere arrangement to avoid the payment of taxes, and the BIR could disregard the tax-free nature of the transaction. In determining the existence of a bona fide business purpose for the merger, each step of the transaction is usually considered and the entire transaction or series of transactions could be treated as a single unit.

Applying the step transaction test is recommended. Under this test, it is advisable to implement each successive step in a merger after the lapse of a certain period of time, say, a year or so. This prevents an examination by the BIR on whether or not a business purpose exists. However, the BIR has not issued a ruling on the acceptable timeframe for each transaction.

Group relief/consolidation

Group tax relief is not applicable under Philippine law. For tax purposes, each legal entity is registered as a separate taxpayer and subject to separate tax filings, and tax consolidations are not possible.

Transfer pricing

The Philippine Tax Code grants the Commissioner of Internal Revenue the power to reallocate income and deductions between and among related entities. The Secretary of Finance's transfer pricing regulations (Revenue Regulations No. 02-2013) provide guidelines for applying the arm's length principle for transfer pricing.

These guidelines state that the most appropriate of the transfer pricing methods under the Organisation for Economic Co-operation and Development's (OECD) transfer pricing guidelines may be used in determining the arm's length result. These methods are:

— comparable uncontrolled price method

— resale price method

— cost plus method

— profit split method

— transactional net margin method.

The guidelines do not prescribe a preference for any one method. Instead, the method that produces the most reliable results, taking into account the quality of available data and the degree of accuracy of adjustments, should be utilized.

The guidelines recognize the authority of the Commissioner of Internal Revenue to make transfer pricing adjustments to ensure that taxpayers clearly reflect income attributable to related-party transactions and to prevent the avoidance of taxes through such transactions.

The documentation supporting the transfer pricing analysis is not required to be submitted upon filing of tax returns. The taxpayer should retain the documentation for the period provided under the Tax Code and be prepared to submit to the BIR when required or requested to do so.

Further, the documentation should be contemporaneous (i.e. existing; prepared at the time the related parties develop or implement any arrangement that might raise transfer pricing issues or prepared when the parties review these arrangements when preparing tax returns).

Dual residency

The Philippines follows the incorporation/domestication rule: a corporation is considered a resident of the country where it is incorporated. Certificates of incorporation or registration and articles of incorporation or association are considered sufficient proof of residency.

Foreign investments of a local target company

Philippine domestic corporations are taxed on their worldwide income at the rate of 30 percent, subject to foreign tax credits in compliance with applicable rules.

Comparison of asset and share purchases

Advantages of asset purchase

— The transferee corporation does not automatically assume liabilities of the transferor corporation.

— The transferor corporation does not automatically dissolve and may continue its separate existence.

— The transferor and transferee corporations may select which assets to transfer or purchase.

— The transfer of all or substantially all of the assets solely for stock is not subject to donor's tax. Under the TRAIN law, as of 1 January 2018, a sale, exchange or other transfer of property made in the ordinary course of business (i.e. a transaction that is bona fide, at arm's length, and free from any donative intent) is considered as made for an adequate and full consideration in money or money's worth), so it is not subject to donor's tax.

— The transfer of all or substantially all of the assets solely for stock is not subject to stamp duty unless the assets transferred involve real property.

— No loss or gain is recognized, provided the conditions in Section 40(C)(2) of the Tax Code are met.

— An asset purchase does not normally need SEC approval, unless the assets are payments for subscription to the capital stock and there is a need to increase the authorized capital stock of the transferee corporation.

— The property purchased by the buyer is subject to depreciation. The buyer may use a different method and rate of depreciation based on the acquisition cost of the property acquired.

Disadvantages of asset purchases

— Unless specifically provided for in the agreement, the transferee corporation does not acquire the rights, privileges and franchises of the transferor corporation.

— The transferee corporation cannot claim any NOLCO of the transferor corporation since the transferor corporation continues to exist as a legal entity.

— The transferor's unused input VAT cannot be absorbed by or transferred to the transferee corporation.

— A transfer of all or substantially all of the assets must comply with the requirements of the Bulk Sales Law.

— A higher purchase price arises in the event of any additional premium or goodwill imputation.

— Acquisition is subject to VAT where the transaction is deemed to be a sale.

— Any real property purchased is subject to stamp duty and VAT.

Advantages of stock purchase

— The buyer may benefit from an automatic transfer of the rights, privileges and franchises by the transferor corporation to the transferee corporation.

— The transferee corporation may claim the NOLCO of the transferor corporation, subject to the provisions of the Tax Code and its regulations. However, in 2012, the BIR ruled that in a statutory merger, the NOLCO of the absorbed corporation is not one of the assets that can be transferred and absorbed by the surviving corporation, as this privilege or deduction is only available to the absorbed corporation. Accordingly, the tax-free merger does not cover the NOLCO of the absorbed corporation that can be transferred and absorbed by the surviving corporation.

— The transferor's unused input VAT may be absorbed by or transferred to the transferee corporation.

— A merger or tax-free exchange may not be subject to donor's tax. Under the TRAIN law, as of 1 January 2018, a sale, exchange or other transfer of property made in the ordinary course of business (i.e. a transaction that is bona fide, at arm's length, and free from any donative intent) is considered as made for an adequate and full consideration in money or money's worth), so it is not subject to donor's tax.

— A merger or tax-free exchange may not be subject to VAT. Under the TRAIN law, as of 1 January 2018, a transfer of property pursuant to Section 40(C)(2) of the Tax Code (e.g. merger, tax-free exchange) is VAT-exempt.

— No loss or gain is recognized, provided the conditions in Section 40(C)(2) of the Tax Code are met.

— A stock purchase may involve a lower purchase price and lower taxes.

Disadvantages of stock purchase

— The transferee corporation may be responsible for all the liabilities and obligations of the transferor corporation as if the transferee corporation had incurred them directly. Any claim, action or pending proceeding by or against the transferor corporation may be prosecuted by or against the transferee corporation.

— It may be necessary to increase the authorized capital stock of the transferee corporation to accommodate the issue of new shares; hence, SEC approval is required.

— The issue of new shares is subject to stamp duty.

— Regulatory compliance is required before the shares are registered in the buyer's name.

KPMG in the Philippines

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Saudi Arabia

Introduction

Saudi Arabia's economic reforms have allowed the economy to grow rapidly in the recent years. Saudi Arabia has implemented various programs to improve the business environment, provide comprehensive service to investors and foster investment opportunities in key sectors of the economy. This is helping the country attract foreign investment and encouraging mergers and acquisitions (M&A).

Among the key recent developments, Saudi Arabia is:

— moving away from an oil-based economy

— introducing new revenue measures in the form of a value added tax (VAT) and excise duty

— amending its current corporate income tax laws and Zakat regulations.

Recent developments: corporate income tax

Saudi Arabia issued a Ministerial Resolution (MR) No. 1727 dated 10 February 2018 (25/05/1439H) amending certain provisions of the Income Tax Law promulgated in 2004.

The key aspects of these amendments are summarized below.

Oil and hydrocarbon producing companies and investee companies

The following amendments are specific to oil and hydrocarbon producing companies.

— The scope of taxable persons has been expanded to include resident capital companies with respect to shares owned directly or indirectly by persons engaged in the production of oil and hydrocarbons.

— The tax base of a company that produces oil and hydrocarbons is calculated after deducting expenses and allowances in accordance with the tax law.

— The amendment will result in a change in tax profile of companies having shares owned, whether directly or indirectly, by Saudi Arabian oil and hydrocarbon producing companies that were previously subject to Zakat on shareholdings attributable to oil and hydrocarbon producing companies. As a result, any income of a Saudi company that is attributable to shares owned, directly or indirectly, by oil and hydrocarbon companies will be subject to corporate income tax (and not to Zakat).

Exempt income

— The scope of tax exemption on gains arising from the disposal of listed securities has been expanded to include securities listed on foreign stock exchanges, provided the shares are also listed on the Saudi stock exchange (Tadawul). This would apply to sales made through the stock exchange or outside of the stock exchange.

— Franked investment income relief has been introduced for local and foreign-sourced dividends. Saudi taxable entities can claim a tax exemption on dividend income in cash or kind (bonus shares) provided the ownership in the investee company is at least 10 percent for at least 1 year before it receives dividends.

Tax losses

— Previously, a company would lose its right to carry forward tax losses on a change in 50 percent or more in the ownership or control of the company. As a result of the recent amendments, a company can now carry forward its tax losses regardless of any change in the ownership or control, provided it keeps on carrying on the same activity.

— It has also been clarified that the transfer of assets between companies would not be considered as a change in ownership or control.

— Losses can be carried forward without time limit by the entity that incurred the loss. However, the maximum deductible accumulated losses in any taxable year should not exceed 25 percent of taxable income for that year. The remaining losses can be carried forward to be offset against taxable income of the following years.

— Accordingly, an acquisition of shares in a company does not cause the acquired company to lose the potential benefit of carrying forward losses, provided the acquired company continues carrying on the same business.

Group relief for asset transfers

— A disposal of assets between wholly-owned group companies (directly or indirectly by capital company) is now disregarded for tax purposes provided the assets remain within the group for at least 2 years after the transfer. Where this relief is claimed, the transfer is considered as made at book value for tax purposes.

— Similarly, when calculating depreciation, the transfer of assets is recognized at book value in both companies.

Recent developments: Zakat regulations

— The tax authorities issued formal zakat regulations in 2017, which consolidate existing zakat practices and Ministerial Resolutions and override all previous zakat circulars, resolutions and instructions. The zakat regulations are applicable as of their date of issuance 28 February 2017 (1/6/1438H).

Recent developments: value added tax

— VAT was implemented as of 1 January 2018 in Saudi Arabia. The VAT applies at a standard rate of 5 percent. Exempt supplies include margin (interest)-based financial services, life insurance and reinsurance services and lease of residential property.

— Zero-rated supplies include international transportation of goods and passengers and ancillary services, exports of goods and services, medicines and certain medical equipment and supplies of qualifying investment metals.

— VAT registration is required for persons having an annual taxable turnover of 375,000 Saudi Arabian riyal (SAR; about 100,000 US dollars — US$), while the threshold for voluntary registration is annual turnover of SAR187,500 (about US$50,000).

— All businesses having annual turnover of more than SAR1 million (US$266,667) were required to register for VAT by 20 December 2017. Businesses with turnover below SAR1 million but above the mandatory registration threshold may register for VAT by 31 December 2018.

— VAT group registration is possible, subject to certain requirements.

— A VAT return must be filed electronically with the tax authorities by the last day of the month following the end of the tax period to which the tax return relates.

— A VAT return is required to be submitted monthly or quarterly, depending on the annual taxable turnover of the registered entity.

— As a general rule (with some exceptions), tax is due on the earliest of the following:

  — making goods or services available to the customer

  — issuing a tax invoice

  — receiving partial or full consideration (within the limit of the amount received).

— Special rules apply for continuous supplies, sales on an instalment basis, supplies of oil, gas, water and electricity, and deemed supplies.

— When claiming a deduction for input VAT, a registered person must have a valid tax invoice issued by the supplier.

— A deduction for input VAT is not allowed for certain procurement.

— Specific rules apply to input VAT paid to procure capital assets.

Recent developments: excise duty

— During 2017, Saudi Arabia also introduced excise tax.

— Excise tax is chargeable on the importation or production of excisable goods released for consumption in Saudi Arabia on or after 11 June 2017.

— Currently, excisable goods broadly include soft carbonated drinks (50 percent rate), energy drinks (100 percent rate) and tobacco products (100 percent rate).

— Excise tax registration is required for anyone intending to import, produce or hold (under a suspension arrangement) any excise goods in Saudi Arabia.

Recent developments: land tax regulations

— The Council of Ministers issued the White Land Tax Law and implementing regulations in June 2016, imposing an annual 2.5 percent tax on the market value of urban white land. This tax applies to empty plots of land allocated for residential or commercial use inside cities' urban zones and owned by individuals and non-governmental legal entities.

— Tax revenues are to be deposited into a special account with the Saudi Arabian Monetary Agency (i.e. Central Bank) and are used to finance housing projects and access to public utilities and services.

Asset purchase or share purchase

Saudi Arabia's foreign investment regulations permit foreign ownership of capital and shares in a Saudi company, provided a foreign capital investment license is obtained.

The Saudi Companies Regulations provides for mergers in which:

— the companies involved are liquidated and their assets and liabilities are contributed to a newly incorporated company; the shareholders of the liquidated companies receive shares in the new company in exchange for their shares in the liquidated companies

— one or more companies are absorbed by an existing company; the shareholders of the absorbed companies receive new shares in the absorbing company.

Acquisitions can also be effected by buying shares in a company, subject to foreign investment regulations.

Purchase of assets

Purchase price

The cost base of an asset purchased, produced, manufactured or constructed by the taxpayer is the amount paid or incurred by the taxpayer in cash or in kind in respect of the acquisition of the asset.

Goodwill

Goodwill paid on the acquisition of shares in a company is considered as part of the base cost and is deductible for determining any gain arising on disposal. The buyer may pay for goodwill in acquiring a business as a going concern. Such goodwill is tax-deductible and can be amortized at a rate of 10 percent on a declining-balance basis for tax purposes.

Depreciation

No gain or loss arises on the disposal of an asset that is depreciable under Saudi tax law. The result of disposal of such assets is dealt with under the depreciation method stipulated by the law.

Tax attributes

Tax in Saudi Arabia consists primarily of corporate income tax, withholding tax (WHT) and zakat. For local companies, corporate income tax is assessed on the share of the profit of the foreign partner in the local company. The corporate income tax rate is 20 percent.

Zakat is a religious levy imposed on Saudi and Gulf Cooperation Council (GCC) nationals and on companies to the extent owned by Saudi or GCC nationals through a GCC-based chain of ownership. The zakat rate of 2.5 percent is applied on the higher of Saudi/GCC share in the zakat base and the Saudi/GCC share in taxable profits of the entity.

Although no specific rules in the corporate income tax and zakat regulations address M&A, any capital gains arising as a result of a sale or transfer of assets (including the entire business) are treated as normal business income and taxed at the normal corporate income tax rates.

Value added tax

The acquisition of a business or part thereof may be considered as a transaction outside the scope of VAT, provided the assets (and liabilities) can be operated as a business unit in their own right (transfer of an economic activity) and certain conditions are met.

Purchase of shares

In a purchase of shares, the purchase price is the cost base for the purposes of determining capital gains tax payable on the shares' later sale. The tax authority may not consider the value of bonus shares as part of the base cost for calculating the taxable gain, as this remains an area of dispute. In some cases, the assessing officers have imposed a 5 percent WHT on the amount of after-tax capital gain by treating the net gain as a distribution of profits (akin to dividend). However, this treatment is contestable at the appellate level.

Pre-sale dividend

In certain circumstances, the seller may prefer to realize part of the value of their investment as income by means of a pre-sale dividend. Such dividend should be subject to a 5 percent WHT and should reduce the amount of sale proceeds and thus the capital gain, which would otherwise be taxed at 20 percent.

Value added tax

The acquisition of shares should be considered as a VAT-exempt transaction.

Transfer taxes

There is currently no stamp duty on the acquisition of shares or assets.

Choice of acquisition vehicle

In Saudi Arabia, foreign investors are not permitted to operate or acquire businesses without first obtaining an investment license from the Saudi General Investment Authority (SAGIA). Foreign investors with a license from SAGIA may directly acquire a Saudi operating company.

The Saudi Arabian foreign investment regulations impose restrictions on available areas of investment through the so-called 'negative list'. The following forms of business entity can be used in Saudi Arabia:

— companies with variable capital

— cooperative companies

— corporations

— general partnerships

— joint ventures

— limited liability companies (LLC)

— limited partnerships

— partnerships limited by shares.

Foreigners generally can carry on businesses through an LLC, branch or joint stock company. International companies may establish representative offices in Saudi Arabia. A representative office should not engage in any commercial activities.

Local holding company

Under Saudi Companies Regulations, a joint stock company or LLC may be established as a holding company if the main purpose of the entity is to participate in joint stock companies or LLCs that are associated with it and with a percentage shareholding enabling it to dominate, control and support them. The holding company's name should include the company type coupled with the word 'holding'.

Foreign parent company

An investor may operate in Saudi Arabia by setting up an LLC. Under the Foreign Capital Investment Law in Saudi Arabia, an LLC can be established with 100 percent foreign ownership. There are minimum capital requirements. In addition, the foreign investor would need to obtain a license from SAGIA and a Commercial Registration Certificate from the Ministry of Commerce and Investment. Under the Companies Regulations, it is possible to establish single-member LLCs. An LLC must transfer 10 percent of its net profit each year to a statutory reserve until this amount equals 30 percent of the LLC's share capital. The entity must withhold tax on dividends and other payments to the non-resident foreign partner, depending on the nature of the payment.

An entity is subject to corporate tax of 20 percent on its taxable profits. Actual expenses incurred specifically and necessarily for generating income are generally tax-deductible.

A company can merge with another company of the same or of a different kind. However, a cooperative company cannot merge with a company of a different kind.

Local branch

A foreign investor may operate in Saudi Arabia through a branch. A branch in Saudi Arabia has a share capital of its own and the minimum invested capital requirement would depend on the nature of activities. In addition, a license from SAGIA and a Commercial Registration Certificate from the Ministry of Commerce and Investment would be required.

A branch has no legal reserve requirements. However, it is required to withhold tax from remittances and profits transferred to the head office. Actual expenses incurred specifically and necessarily for generating gross income are generally tax-deductible. For branches of foreign companies, certain limitations apply to restrict the tax-deductibility of expenses.

Joint ventures

Foreign investors may establish an LLC or joint stock company with a Saudi partner. The corporate tax is assessed on the foreign shareholder's share of the entity's taxable income. Saudi tax law also permits unincorporated joint ventures, which are considered as partnerships for tax purposes.

Choice of acquisition funding

The investment may be financed on either the local or foreign market. No limitations apply to local financing.

It is possible to finance an acquisition through a share capital contribution and/or with debt. There are no specific rules under the corporate income tax law regarding thin capitalization, although SAGIA imposes minimum capital requirements.

There are WHT implications for payments of interest or dividends to non-resident shareholders in a Saudi company. Interest expenses also are subject to certain limitations under Saudi tax law.

Debt

Companies may finance their operations through bank loans or the issuance of capital market debt instruments, but there are some restrictions on issuing debt securities.

Deductibility of interest

Under Saudi tax law, deductions for interest expense are restricted to the lesser of interest expense incurred during the tax year and the result of the following formula:

The taxpayer's total income from loan charges (interest), plus 50 percent of (a) minus (b) where:

a = income subject to tax other than income from loan charges

b = expenses allowed under the law other than loan charge expenses.

Withholding tax on debt

According to the Saudi tax law, WHT at a rate of 5 percent is payable on the gross amount of actual interest paid or settled to a non-resident lender.

Under Saudi tax law, 'interest' is defined as any amount paid for the use of money. This includes income realized from loan transactions of any type, whether secured with guarantees or with rights to participate in the borrower's profits. Interest also includes income realized from government and non-government bonds.

Equity

According to the Saudi Companies Regulations, LLCs must fully pay their capital and retain it in a local bank account until the company's regulatory requirements are met.

Unlike LLCs, joint stock companies may raise capital by issuing shares. The shares must be nominal shares and may not be issued at a value higher than their nominal value, unless such a premium is stated in the company's articles of association and agreed by the shareholders. The share premium is then added to the company's statutory reserve.

Other considerations

Concerns of the seller

The tax position of the seller can be expected to have a significant influence on any transaction. In certain circumstances, the seller may prefer to realize part of the value of their investment as income by means of a pre-sale dividend. In this case, the dividend may be subject to 5 percent WHT but reduces the proceeds of the sale and thus the gain on the sale, which may be subject to 20 percent capital gains tax.

Company law and accounting

All business entities are required to maintain a journal, general ledger and inventory book in Saudi Arabia in Arabic. In addition, all original supporting documentation for all entries recorded in the accounting books must be maintained locally to enable the government authorities to request and review them at any time. According to the Saudi Accounting Regulations and in practice, all books and records usually must be retained for at least 10 years.

Audit of financial statements

Currently, an LLC/branch is required to prepare financial statements and have them audited by a locally licensed accountant. Financial statements should conform to the standards of the Saudi Organization for Certified Public Accountants.

Saudi Arabia has converted to International Financial Reporting Standards) (IFRS). Listed entities were required to adopt IFRS from 1 January 2017, and unlisted entities from 1 January 2018.

Transfer pricing and anti-avoidance

Saudi Arabia has no specific transfer pricing rules. However, the tax law provides for certain measures against tax avoidance. In determining the tax liability, the tax authorities have the right to:

— disregard a transaction that has no tax effect

— reclassify a transaction whose form does not reflect its substance according to its reality

— raise an arbitrary assessment on a taxpayer according to the relevant facts and circumstances where a taxpayer fails to make timely filing of its declaration, does not maintain accurate accounts and records, or fails to maintain accounts and records in the required form and manner

— allocate income or deductions between related persons or persons under common control as necessary to reflect the income that would have resulted from a transaction between independent persons (arm's length principle)

— adjust tax assessable profits if an individual taxpayer attempts to split income (as defined in the law) with another taxpayer to reduce the tax liability.

Under Saudi tax law, companies are considered related if they are 50 percent or more owned or controlled by the same person, whether directly or indirectly. For capital companies, 'control' is defined as ownership of the voting power or value in the company held directly or indirectly through one or more subsidiary of any type of company.

In addition to the above and based on the Ministerial Resolution (No. 1776) dated 19 March 2014, the tax authorities would issue guidelines/regulations on transfer pricing of transactions between related parties in accordance with the internationally accepted standards. At the time of writing, detailed transfer pricing guidelines were expected to be issued in the next few months.

Relevant regulations and rulings

The tax authorities have not yet issued any transfer pricing regulations or rulings.

OECD transfer pricing guidelines

Saudi Arabia is not a member of the Organisation for Economic Co-operation and Development (OECD). The OECD transfer pricing guidelines are not binding on the Saudi Arabian tax authority, but the tax authorities do expect transactions between related parties to be on an arm's length basis. KPMG in Saudi Arabia believes that the principles set out in the OECD guidelines should be accepted by the tax authorities, as most tax treaties signed by Saudi Arabia are based on the OECD guidelines.

Priorities/pricing methods

No specific transfer pricing methods are prescribed in the tax law, so there is no hierarchy or priority to govern which transfer pricing methods should be applied. If a taxpayer in Saudi Arabia adopts and properly implements a global transfer pricing policy that is based on the commonly accepted transfer pricing methods set out in the OECD guidelines, then the tax authorities may accept that methodology.

Transfer pricing penalties

There is currently no specific transfer pricing penalty prescribed under the law. However, penalties prescribed under the general provisions of the Saudi tax law would apply on any assessed differences.

Penalty relief

No penalty relief is currently available under the Saudi tax law.

Documentation requirements

There is currently no requirement for taxpayers in Saudi Arabia to prepare contemporaneous transfer pricing documentation or for documentation to be submitted to the tax authorities together with the filing of tax declaration. Nonetheless, the taxpayer should maintain adequate documents to support their transactions.

Statute of limitations on transfer pricing assessments

There is no specific statute of limitations set out in the Saudi tax law for transfer pricing assessments. The general statute of limitation under the tax law is 5 years, and 10 years where the tax return was not filed or if filed, was found to be incomplete or incorrect with the intent of tax evasion.

Return disclosures/related-party disclosures

The tax law does not require taxpayers to submit an information return to disclose related-party transactions. However, the online filing system (ERAD) introduced by the tax authorities and the system's unified declaration requires entities to disclose the movement of the related-party balances.

Specific transfer pricing returns

Separate tax returns are currently not required for related-party transactions.

Tax audit frequency and transfer pricing scrutiny

Transactions involving related parties are reviewed in depth by the tax authorities to verify whether the transactions were made on an arm's length basis.

Dual residency

The concept of dual residency is not relevant in Saudi law. However, for Saudi tax purposes, a company is a resident company if either:

— it is formed under the Companies Regulations

— its place of central control and management is situated within Saudi Arabia.

Foreign investments of a local target company

The following rules apply on the treatment of investments in foreign entities for zakat purposes in Saudi Arabia.

Holding companies and their wholly owned subsidiaries are required to submit consolidated financial statements that include the holding company and its subsidiaries, whether the subsidiaries are registered inside or outside Saudi Arabia. The zakat assessment is on a consolidated basis as one unit and one zakat base.

Additionally, investments in entities outside Saudi Arabia — joint ventures — are deducted from the zakat-payer, provided either:

— the zakat-payer submits financial statements audited by a certified public accountant authorized in the investee country for the purpose of calculating the zakat due on such investments and pays the zakat due to the department

— the zakat-payer submits proof of zakat payment in the country of the investee and then deducts the investments from the zakat base of the Saudi investing company to avoid duplication of zakat in these companies.

If the zakat-payer fails to comply with these requirements, the investments may not be deducted from their zakat base.

Finally, any investment — local or abroad — in forward transactions or in sukuks representing a debt are not deductible from the zakat base, regardless of the issuer's location and the period of the investment.

Developments affecting Saudi holding companies

Income realized by a resident company from investments in other Saudi-resident companies is not taxable for the investor company, provided that:

— the underlying income has been subject to Saudi tax

— the shareholding percentage owned by the investor company in the investee company is at least 10 percent

— the shares in the investee company are held for at least 1 year.

Further, income from investments and operations outside Saudi Arabia is taxed in the country unless a tax treaty in force between Saudi Arabia and the country of the investee states otherwise.

Comparison of asset and share purchases

Advantages of asset purchases

— The purchase price (or a proportion) can be depreciated or amortized for tax purposes (including goodwill), a step-up may be achieved.

— Possible to acquire only part of a business.

— For GCC shareholders, the value of fixed assets may be deducted from the company's zakat base.

— The company is not required to carry any risk of unsettled tax and Zakat liabilities relating to investee company for pre-acquisition years.

Disadvantages of asset purchases

— Possible need to renegotiate supply, employment, technology and other agreements.

— Capital gains arising as a result of a sale or transfer of assets (including the entire business) are treated as normal business income and taxed at the normal corporate income tax rates.

— Capital gains on disposals of certain assets (including shares in an unlisted Saudi company) are determined according to the sale value and cost price at the time of the transaction. Certain specific rules apply to asset sale transactions.

Advantages of share purchases

— A capital gain realized on a sale of securities traded on Saudi Arabia's stock market is tax-exempt if the securities are sold in accordance with Saudi stock market regulations and the securities did not exist before 31 July 2004.

— The holding structure may be optimized, especially for a foreign investor.

Disadvantages of share purchases

— Capital gains arising to a non-resident from the sale of shares in a local company are subject to tax at a rate of 20 percent.

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Singapore

Introduction

The Republic of Singapore is an island state and member of the British Commonwealth.

Income is taxed in Singapore in accordance with the provisions of the Income Tax Act (Chapter 134) (ITA) and the Economic Expansion Incentives (Relief from Income Tax) Act (Chapter 86).

Generally, the Comptroller of Income Tax is vested with the powers to administer the country's tax legislation. Certain tax incentives are administered by other statutory boards, such as the Economic Development Board (EDB) and Enterprise Singapore (resultant entity of merger of International Enterprise Singapore and Spring Singapore).

Goods and services tax (GST) and stamp duty are levied in accordance with the Goods and Services Tax Act (Chapter 117A) and the Stamp Duties Act (Chapter 312).

Recent developments

Singapore's mergers and acquisition (M&A) scheme was introduced in 2010 to encourage companies to grow their businesses. The M&A scheme comprises the M&A allowance and stamp duty relief, which can be claimed by an acquiring company.

In 2012, a 200 percent tax allowance on transaction costs incurred on qualifying M&A was introduced to further support companies carrying out M&A. The M&A scheme was further enhanced in 2015 and 2016.

Details of the M&A scheme can be found in 'Purchase of shares' later in this report.

Asset purchase or share purchase

An acquisition in Singapore can take the form of a purchase of assets and business, or a purchase of shares of a company. The choice is influenced by factors such as the treatment of the gains as revenue or capital (there is no capital gains tax in Singapore), the likely recapture of capital allowances by the seller, and the amount of stamp duty payable on asset purchases versus share purchases. Some of the tax considerations relevant to each method are discussed later in this report. The advantages and disadvantages of each method are summarized at the end of the report.

Purchase of assets

A purchase of assets may give rise to income tax and stamp duty implications for the seller and buyer. Depending on the tax status of the seller, the disposal gains may be regarded as trading gains subject to income tax. Where the asset is a real property, the amount of stamp duty payable on transfer may be substantial. Unless otherwise agreed, the buyer usually pays such duty. Where capital allowances have been claimed on the assets, they may be recaptured by and taxable to the seller, depending on the consideration.

Purchase price

For tax purposes, it is necessary to apportion the total consideration among the assets acquired. Hence, it is advisable to specify in the sale and purchase agreement an allocation that is commercially justifiable. For trading stocks, the transfer can be at net book value, provided the stocks also constitute trading stocks of the buyer. This is to ensure tax-neutrality on the transfer. Otherwise, the open market value is substituted as the transfer value.

Goodwill

For tax purposes, the amount of goodwill written off or amortized to the income statement of the company is non-deductible on the basis that the expense is capital in nature.

Depreciation

The ITA contains provisions for granting initial and annual tax depreciation allowances on capital expenditure incurred on qualifying assets used for purposes of the taxpayer's business (subject to certain conditions). The main rates of initial and annual allowances are summarized below.

Tax depreciation (commonly referred to as capital allowances) is granted for plant and machinery used in a trade, business or profession. Plant and machinery are classified into working lives of 5, 6, 8, 10, 12 or 16 years for tax-depreciation purposes.

With the exception of certain assets, all plant and machinery can be depreciated under the alternative accelerated allowances scheme of 3 years. Some assets, including prescribed automation equipment (e.g. robots, computers), power generators installed in factories or offices as back-up

units in the event of power failures, and efficient pollution control equipment, can be written off in 1 year. A 100 percent write-off is also available on qualifying fixed assets where the cost of each asset is no more than 5,000 Singapore dollars (SGD). The aggregate claim for 100 percent write-off of all such assets is capped at SGD30,000 per year of assessment (YA).

Writing-down allowances (WDA) are granted on qualifying capital expenditure incurred by a company in acquiring intellectual property rights (IPRs) from 1 November 2003 to the last day of the basis period for YA 2020 for use in its trade or business. The transferee must acquire the legal and economic ownership of the IPRs from the transferor to be eligible for WDA. An application for a waiver from legal ownership can be made to the EDB. A third-party independent valuation report on the value of the IPRs acquired is required to be submitted for certain scenarios.

As of YA 2017, an irrevocable election to claim WDA over a 5, 10 or 15-year period (on a straight-line basis) will have to be made via a declaration form on filing the income tax return for the first YA of the WDA claim.

Land intensification allowance, comprising an initial (one-time) allowance of 25 percent and an annual allowance of 5 percent, is available on capital expenditure incurred for the construction or renovation/extension of a qualifying building or structure, subject to qualifying criteria.

For YA 2011 to YA 2018, companies are entitled to claim productivity and innovation credits (PIC) for incurring qualifying expenditure on any of six prescribed qualifying activities. The PIC scheme will expire after YA 2018.

Where a company disposes of plant and machinery or IPRs, a balancing charge or balancing allowance normally arises to adjust for the difference in the residual or tax written-down value (TWDV) of the asset as compared to the consideration received for the asset. A balancing allowance is available to the company when the TWDV of the asset is greater than the consideration received. Conversely, where consideration exceeds the TWDV, a balancing charge is made (restricted to the capital allowances or WDA allowed previously in respect of the asset).

Tax attributes

In the case of an asset or business transfer, the unused tax losses and capital allowances remain with the company unless the transfer is a qualifying corporate amalgamation.

Goods and services tax

Generally, goods and services tax (GST) is chargeable at 7 percent on any supply of goods and services made by a GST-registered entity in the course or furtherance of its business.

The transfer of a business (or a part of the business that is capable of separate operation) as a going concern is treated as neither a supply of goods nor services for GST purposes on which GST is not chargeable. This applies only where the business (or part of that business) is a going concern at the time of the transfer, the transferee is a GST-taxable person and the assets are to be used by the transferee in an existing or new business of the same kind as that carried on by the transferor. The mere transfer of assets is not conclusive evidence that the transfer is a transfer of a business as a going concern. The general rule is whether the transaction puts the transferee in possession of a going concern, the activities of which could be carried on without interruption. Where Inland Revenue Authority of Singapore (IRAS) is not convinced that the transfer is that of a transfer of business as a going concern, GST at 7 percent is applicable on the entire disposal value (including any consideration for goodwill or intangibles).

Conversely, if the business transfer is a transfer of business as a going concern but 7 percent GST has been erroneously levied on such transaction, the IRAS has the discretion to disallow the GST incurred by the transferee and claimed as an input tax credit.

Transfer taxes

Stamp duty is payable on documents relating to the sale or transfer of immovable properties and shares in accordance with the Stamp Duties Act.

Sale and purchase of immovable property

Stamp duty payable on documents relating to the sale or transfer of immovable properties is computed based on the higher of the purchase consideration or the market value of the immovable property located in Singapore.

Buyer's Stamp Duty (BSD) is payable by the buyer at the following rates:

Value	Buyer's Stamp Duty rate
On the first SGD180,000	1 percent
On the next SGD180,000	2 percent
On any remaining balance	3 percent

Additional Buyer's Stamp Duty (ABSD) may be payable by the buyer on top of BSD for acquisitions of residential property located in Singapore, depending on the profile of the buyer. In particular, foreigners and non-individuals buying residential property located in Singapore must pay ABSD of 15 percent on the purchase.

Seller's Stamp Duty (SSD) is payable by the seller and applies to the following:

— Residential properties purchased from 14 January 2011 to 10 March 2017 (both dates inclusive), and disposed of within 1, 2, 3 or 4 years of purchase are subject to stamp duty of 16 percent, 12 percent, 8 percent and 4 percent respectively.

— Residential properties purchased on or after 11 March 2017 and disposed of within 1, 2 and 3 years of purchase are subject to stamp duty of 12 percent, 8 percent and 4 percent respectively.

— Industrial properties purchased on or after 12 January 2013 and disposed of within 1, 2 or 3 years of purchase are subject to stamp duty of 15 percent, 10 percent and 5 percent respectively.

Sale and purchase of shares

Stamp duty is payable on documents relating to the sale and transfer of shares in a Singapore company that is executed in Singapore. The rate of duty is 0.2 percent on the higher of the consideration or the value of the shares.

IRAS will carry out back-end audit checks to ensure the amount of duty paid reflects the true value of the shares transferred, especially for non-arm's length transfers.

Sale and purchase of residential property-holding entities

In addition to existing stamp duty on shares, certain acquisitions or disposals of equity interests in residential property-holding entities (PHE) attract additional conveyance duty (ACD).

The rates of ACD for buyers are:

— 1 percent to 3 percent of the market value of the underlying residential property

— 15 percent (flat rate) of the market value of the underlying residential property.

The rate of ACD for sellers (where equity interest is disposed of within 3 years of acquisition) is 12 percent (flat rate) of the market value of the underlying residential property.

Relief from stamp duties

Several kinds of relief are provided by the Stamp Duties Act. Approval is required from the Commissioner of Stamp Duties. The key reliefs are as follows:

— Relief from stamp duty in connection with a scheme for the reconstruction or amalgamation of companies, provided the following key conditions, among others, are met:

  — the acquiring company must be registered or incorporated in Singapore, or

  — it must have increased its capital with a view to acquiring either the undertaking or not less than 90 percent of the issued share capital of any particular existing company

— Relief from stamp duty on a transfer of property between associated permitted entities, provided the following key conditions, among others, are met:

  — the effect of the transaction is to transfer a beneficial interest in immovable property or shares from one associated permitted entity to another associated permitted entity

  — the permitted entities (LLPs or companies) are associated as follows:

    — one entity is the beneficial owner of not less than 75 percent of the voting share capital and more than 50 percent of the voting power of the other, or

    — a third entity is the beneficial owner of not less than 75 percent of the voting share capital and more than 50 percent of the voting power of both entities.

As of 11 March 2017, relief is not granted on transfers involving residential PHEs where ACD is applicable.

For qualifying share acquisitions under the M&A scheme, stamp duty relief is available of up to SGD80,000 for each financial year from 1 April 2016 to 31 March 2020 (see next section).

Mergers and acquisitions scheme

The M&A scheme was introduced in 2010 to encourage companies in Singapore to grow their business through M&A. The M&A scheme was further enhanced in 2015 and 2016. Under the enhanced scheme, an M&A allowance for each YA equal to 25 percent of the value of acquisition is granted for qualifying shares acquired from 1 April 2016 to 31 March 2020, subject to a maximum cap of SGD10 million. This cap effectively allows for qualifying share acquisitions made from 1 April 2016 of up to SGD40 million in aggregate in each YA. The M&A allowance is claimed over 5 years on a straight-line basis.

Stamp duty relief may also be granted on the sale and transfer of ordinary shares, subject to the requirements of the M&A scheme. The maximum stamp duty relief is capped at SGD80,000 for each financial year (from 1 April 2016 to 31 March 2020).

For qualifying share acquisitions completed during the period from 17 February 2012 to 31 March 2020, a 200 percent tax allowance is granted in the form of double tax deduction on transactions costs (net of grants or subsidies from the Government or any statutory board), subject to a cap of SGD100,000 per YA. Transaction costs are professional fees that are necessarily incurred for the qualifying share acquisition such as legal fees, accounting and tax advisors' fees, valuation fees etc. However, any such fees or incidental cost in respect of loan arrangements such as borrowing costs, stamp duty and any other taxes are excluded.

Key aspects of the M&A scheme are as follows:

— available to Singapore-resident companies that purchase the ordinary shares of another company directly or indirectly (for acquisitions made on or after 17 February 2012) through a wholly owned holding vehicle

— where the acquiring company belongs to a corporate group, the ultimate holding company of the acquiring company must be incorporated and tax-resident in Singapore (may be waived on a case-by-case basis)

- acquiring company is carrying on a trade or business in Singapore on the date of share acquisition, has at least three local employees (excluding company directors) throughout the 12-month period prior to the date of the share acquisition, and is not connected to the target company for at least 2 years prior to the date of the share acquisition
- where the acquiring company uses a subsidiary to make the acquisition, the subsidiary must be a wholly owned subsidiary, must not carry on a trade or business in Singapore or elsewhere on the date of the share acquisition, and must not claim any deduction for capital expenditure of claim M&A allowance or stamp duty relief under the M&A scheme
- must result in the acquiring company owning (for share acquisition during the period from 1 April 2015 to 31 March 2020):
  - 20 percent of the ordinary shares of the target company if, before the date of acquisition, it owned less than 20 percent of the ordinary shares in the target company, or
  - more than 50 percent of the ordinary shares of the target company if, before the date of acquisition, it owned 50 percent or less of the ordinary shares in the target company.

The M&A scheme is not available to asset acquisitions.

Tax losses

The unabsorbed trade losses (and capital allowances) generated by the target company are transferred along with the company and are available for carry forward for set-off against the company's future years' taxable profits, subject to the shareholders' continuity test. The test effectively requires that not less than 50 percent of the total number of issued shares of the company were held by or on behalf of the same shareholders at relevant comparison dates.

Additionally, the company must carry on the same trade or business in order to utilize the unabsorbed capital allowances.

The shareholders' continuity test is intended to target situations where loss-making companies are being acquired for tax reasons. Where a substantial change in ultimate shareholding takes place, local tax laws still provide the relevant company with an avenue to appeal to the Minister for Finance (or such person as he may appoint) to waive the shareholders' continuity test. The Minister is likely to examine the appeal based on its merits. Where such a waiver is obtained, the Singapore company can continue to carry forward its unabsorbed trade losses and/or capital allowances but only for set-off against future taxable profits arising from the same trade that gave rise to the relevant losses and/or capital allowances.

Any person carrying on a trade, business, profession or vocation may carry back their current-year unabsorbed capital allowances and current-year unabsorbed trade losses (up to SGD100,000) for set-off against their assessable income of the YA immediately preceding the YA in which the capital allowances were granted or the trade losses were incurred. The carryback relief is subject to the shareholders' continuity test. Current-year unabsorbed capital allowances are also subject to the same business test.

Unabsorbed M&A allowance and double tax deduction on transaction costs are not available for carry back to set off the acquiring company's assessable income for preceding years.

Pre-sale dividend

Under certain circumstances, the seller may prefer to realize part of their investment as a pre-sale dividend because dividends paid by Singapore-resident companies are tax-exempt.

Goods and services tax

Generally, the disposal of shares is a GST-exempt supply. However, where the transferee is a person belongs outside Singapore, the supply is zero-rated for GST purposes.

While output GST is payable in both transactions, there is implication on the claiming of input GST credits. Generally, no input GST is allowed for the making of exempt supplies arising from share disposal unless certain qualifying conditions are met. However, any input GST incurred for making zero-rated supplies including that from shares sold to persons belonging outside Singapore is claimable.

Tax indemnities and warranties and tax clearance

On taking over the target company, the buyer assumes all related liabilities, including contingent liabilities. It is not possible to obtain a clearance from the IRAS that a potential Singapore target company has no tax arrears.

Therefore, the buyer usually requires indemnities and warranties in the sale agreement. The extent of the indemnities or warranties is subject to negotiation between the seller and buyer. Where the sums involved are significant, the buyer normally initiates a due diligence exercise, including a review of the target company's tax affairs to ascertain the tax position of the target company and identify potential tax liabilities.

Choice of acquisition vehicle

Singapore adopts a territorial system of taxation and the corporate tax regime applies equally to Singapore incorporated entities and foreign entities carrying on business in Singapore through vehicles such as a Singapore branch or permanent establishment. The main types of vehicle (described in more detail below) that may be used to acquire shares or assets in Singapore or to carry on a business in Singapore include the following:

— Singapore-incorporated company (including local holding company)

— foreign parent company

— non-resident intermediate holding company

— branch of a foreign company

— foreign corporate entity that transferred its registration to Singapore under the inward re-domiciliation regime

— Singapore-registered business trust

— partnership

— limited liability partnership

— limited partnership

— other vehicles.

Local holding company

It can be tax-advantageous for foreign investors to establish a Singapore holding company to acquire shares or assets in (or outside) Singapore. The primary tax advantages that could arise are as follows:

— Group relief arising from the option to transfer current-year losses, current-year unabsorbed capital allowances, and donations within qualifying group companies (i.e. Singapore incorporated companies) may be available.

— Foreign-sourced dividends, foreign branch profits and foreign-sourced service income, which are taxable when received in Singapore by a Singapore resident company, may be exempt from Singapore tax where certain conditions are met. Alternatively, Singapore tax arising on such income may be mitigated or effectively eliminated through Singapore's unilateral tax credit system and bilateral tax agreements, provided foreign tax has been paid on the income.

— Gains on the disposal of Singapore or foreign investments/ assets are not subject to Singapore tax where the gains are capital gains because Singapore has no capital gains tax regime. So, unless the acquisition of an asset or subsidiary is regarded as being on trading account, any gains arising from its subsequent disposal are not taxed.

For Singapore tax purposes, the tax residency of a company is determined by its place of management and control. The management and control of a company vests in its board of directors (BOD) and where the BOD meets normally determines the entity's place of management and control. To the extent that the BOD holds its meetings in Singapore to deliberate on and make strategic decisions concerning the Singapore entity, the IRAS normally accepts that the entity is a tax-resident of Singapore. However, for a foreign-owned company (50 percent or more of its shares held by foreign companies/shareholders), the IRAS is more stringent and requires the company to provide evidence to substantiate that its control and management is indeed in Singapore.

Foreign parent company

The foreign buyer can make the acquisition itself. Singapore does not normally tax the gains of a foreign company disposing of Singapore shares unless those shares are held for the purpose of a trade carried on through a Singapore branch. Singapore does not impose withholding tax (WHT) on dividends. However, the following payments to non-residents made by a resident person or permanent establishment in Singapore are subject to WHT in Singapore:

— interest and any payment in connection with a loan or indebtedness

— management, technical assistance and service fees where services are performed in Singapore

— royalties

— rent or any payment for use of movable property

— directors' remuneration.

Non-resident intermediate holding company

An intermediate holding company resident in another country can be interposed to take advantage of a favorable tax treaty with Singapore. However, certain Singapore tax treaties contain anti-treaty shopping provisions that would render ineffective any structure set up solely to derive tax benefits.

Local branch

A branch of a foreign corporation is regarded as constituting a part of the same legal entity as its head office. As the Singapore branch normally is managed and controlled out of its foreign head office, most Singapore branches are regarded as non-residents of Singapore for tax purposes. This is on the premise that the board meetings of the foreign entity are held outside Singapore. From a Singapore income tax perspective, a branch of a foreign corporation generally is taxed no differently from a subsidiary company. There is usually no difference in the tax rates or variation in the methodology for computing the taxable profits for a branch and a subsidiary company.

As an investment vehicle, there are some inherent tax disadvantages in a Singapore branch, compared to a local company. The foreign income exemption provisions mentioned earlier are not available to a non-resident. Singapore branch. Additionally, a non-resident entity cannot take advantage of the tax benefits and concessions accorded under Singapore's tax treaties, which have been concluded with more than 84 countries for double taxation relief. The non-resident entity also does not qualify for the unilateral tax relief provisions under the ITA that would relieve qualifying foreign income from Singapore taxation.

Foreign corporate entity transferring registration to Singapore

As of 11 October 2017, a foreign corporate entity (FCE) is allowed to transfer its registration to Singapore under the inward re-domiciliation regime. Once re-domiciled, the FCE becomes a Singapore company registered under the Accounting and Corporate Regulatory Authority of Singapore (ACRA) and must comply with the the Singapore Companies Act. Benefits of re-domiciliation may include the availability of financial or fiscal incentives, a more conducive tax or regulatory environment, improved access to financial and capital markets and closer proximity to the FCE's shareholders or operational base.

To transfer its registration to Singapore, a FCE must meet the following requirements:

1. Minimum size requirements (any two of the following criteria):
   - the value of the FCE's total assets exceed SGD10 million
   - the annual revenue of the FCE exceeds SGD10 million
   - the FCE has more than 50 employees.

   An FCE that is a parent is assessed based on consolidated financial statements. An FCE that is a subsidiary may rely on its parent's consolidated financial states to satisfy the size requirement if its parent is a Singapore-incorporated company that meets the size requirement or its parent is a FCE that has transferred its registration to Singapore.
2. Minimum solvency criteria:
   - there are no grounds on which the FCE could be found to be unable to pay its debts
   - the FCE is able to pay its debts as they become due during the period of 12 months after the date of the application for transfer of registration
   - the FCE is able to pay its debts in full within the period of 12 months after the date of winding up (if it intends to wind up within 12 months after applying for transfer of registration)
   - the value of the FCE's assets is not less than the value of its liabilities (including contingent liabilities).
3. Other requirements:
   - the FCE must be authorized to transfer its incorporation under the law of its place of incorporation
   - the FCE must comply with the requirements of the law of its place of incorporation in relation to the transfer of its incorporation
   - the application for transfer of registration is not intended to defraud existing creditors of the FCE and is made in good faith
   - the FCE must not be under judicial management, not in liquidation or being wound up.

Registered business trust

Business trusts (BT) are businesses structured in the form of trusts. A BT is created by a trust deed under which the trustee has legal ownership of the assets and manages the assets for the benefit of the beneficiaries of the BT. Unlike a company, a BT is not a separate legal entity. Unlike a private or unit trust, a BT actively runs and operates a business or trade. Under the Business Trusts Act (BTA), a BT must be run by a single responsible entity, known as the trustee-manager, which must be incorporated in Singapore.

Unlike companies, BTs are not restricted to paying dividends out of accounting profits; they can make distributions to their investors out of operating cash flow.

For income tax purposes, a BT (registered under the BTA) is treated like a company. The income of a registered BT is taxable at the trustee level, and the registered BT is treated like a company under the one-tier system. The beneficiaries or unit holders of the registered BT are not taxed on their shares of the statutory income (of the trustee) to which they are beneficially entitled. The beneficiaries or unit holders are not allowed any credit for the tax paid by the trustee of the registered business trust. Group relief provisions only apply to a registered BT that is established in Singapore, has trust deeds executed in Singapore, and is governed by Singapore law.

Partnership

A partnership is not taxed as an entity. Tax is instead charged at the partner level on the partners' shares of the adjusted income from the partnership. The divisible income is allocated among the partners according to their profit-sharing formula, and capital allowances (also allocated according to a profit-sharing formula) are deducted in arriving at the partners' chargeable income. Where there is a partnership loss, each partner may offset their share of the loss against their respective income from other sources.

Goods and services tax

A GST remission is granted to a registered BT that carries on certain qualifying businesses, namely infrastructure business, aircraft leasing and ship leasing ("qualifying RBT"), allowing them to claim input GST incurred on allowable business expenses regardless of whether they are registrable for GST ,provided that qualifying RBT:

- is listed or to be listed on the Singapore Exchange
- has veto rights over key operational issues of its special purpose vehicles (SPV) (e.g. changes to the equity capital structure of the SPVs) holding the underlying assets

— the underlying assets of the qualifying RBT make taxable supplies or out-of-scope supplies that would be taxable supplies if made in Singapore.

As of 1 April 2015, and subject to meeting the qualifying conditions above, a qualifying RBT is also allowed to claim input GST on business expenses incurred to set up financing SPVs and their allowable business operating expenses, provided all funds raised by the financing SPV is on-lent to the qualifying RBT to finance its taxable business activities.

The GST remission expires on 31 March 2020.

Limited liability partnership

An LLP must be registered under the Limited Liability Partnerships Act. An LLP is regarded as a legal entity separate from the partners and confers limited liability on them. It has perpetual succession, so a change in partners does not affect its existence, rights or liabilities. An LLP is tax-transparent; it is not taxed at the entity level. Tax is chargeable on each partner based on the applicable income tax rate.

Where an LLP partner has unabsorbed capital allowances, industrial building allowances, qualifying donations or trade losses, the amount allowed for set-off against their income from other sources (relevant deductions) is restricted to the amount of their contributed capital.

When the contributed capital of an LLP partner is reduced and the reduction results in the partner's past relevant deductions exceeding the reduced contributed capital, the excess is deemed to be taxable income of the partner.

The admission of a new partner or withdrawal of an existing partner owing to retirement, death or other reasons does not result in a cessation of the business of all the partners, unless there is evidence of a change in the business carried on through the LLP.

Limited partnership

Limited partnerships (LP) in Singapore are governed by the Limited Partnership Act, which was enacted in 2008. The LP is a business structure that functions as a partnership with no separate legal personality from its partners. LPs generally comprise at least one general partner with unlimited liability and one or more limited partners that enjoy limited liability.

For Singapore tax purposes, an LP is accorded tax-transparency treatment like LLPs and general partnerships. The tax treatment for limited partners of an LP is the same that for partners of an LLP. The general partners of an LP are treated for tax purposes the same as partners of a general partnership.

Any of the general partners of an LP may assume the role of precedent partner for the purposes of notice of chargeability and filing of tax returns.

Where an LP is dissolved, the general partner(s) of the LP must wind up its affairs, unless a court orders otherwise.

Other vehicles

An unincorporated joint venture that is not a partnership is not a legal person, so it is not taxable in its own right. Tax is instead charged to the respective joint ventures on their shares of the tax-adjusted income from the joint venture.

Trust income of a unit trust is treated as the trustees' income and is subject to tax at the normal corporate tax rate. Unit holders declare their share of the trust income and obtain a credit on tax paid at the trust level.

Tax concessions are available to approved unit trusts (AUT) and designated unit trusts (DUT):

— For an AUT, only 10 percent of the gains derived from the disposal of securities is subject to tax. The remaining 90 percent is tax-exempt.

— For a DUT, specified income and gains are tax-exempt at the trust level. Specified income and gains include gains from the sale of securities, interest income (other than interest on which Singapore tax may have been deducted at source) and foreign dividends received in Singapore.

Singapore has one of the world's most effective tax regimes for real estate investment trusts (REIT). In Singapore, a REIT is established as a unit trust and is regulated by the Monetary Authority of Singapore. The REIT is managed by an asset manager and administered by a trustee, both of which are set up as companies limited by shares. Generally, REITs in Singapore are listed on the Singapore Exchange and their units are freely tradable.

A number of tax concessions may be granted to REITs. They include:

— Tax transparency treatment applies at the trustee level where the trustee is not assessed tax on the REIT's taxable income that is distributed to the unit holders.

— REIT distributions to unit holders who are individuals are tax-exempt, unless they hold their units through a Singapore partnership.

— Foreign-source income may be exempt from tax in Singapore.

— The WHT rate for non-resident institutional investors is reduced to 10 percent for distributions made from 18 February 2005 to 31 March 2020.

— A GST remission is allowed for claims of input GST incurred on business expenses for acquiring and holding non-residential properties through the REIT's multi-tiered structure until 31 March 2020, subject to qualifying conditions similar to those for qualifying RBTs.

For those REITS that are liable to register for GST due to their direct holdings of non-residential properties in Singapore to derive taxable rental income, they will still be required to register for GST in their own rights.

The GST remission allowing qualifying RBTs to claim input GST on business expenses incurred to set up financing SPVs and their allowable operating expenses also applies to REITs, subject to the same qualifying conditions.

Choice of acquisition funding

A transaction can be financed through shares, loan notes, cash, asset swaps or a combination of different types of consideration.

Debt

Where the consideration is in the form of cash, the acquirer may have to raise external borrowing. Incidental costs of raising loan financing, such as legal fees, rating fees and guarantee fees, are normally viewed as non-deductible capital costs. Exceptions arise where such expenditure is integral to the operations of a trade or business, thereby qualifying as deductible revenue expenditure, as in the case of banks and other financial institutions.

'Qualifying debt securities' (QDS) are defined as Singapore government securities, bonds, notes, commercial papers, treasury bills, certificates of deposit and Islamic debt securities issued by qualifying entities. The main tax concessions for QDS are as follows:

— tax exemption on interest, discounts, prepayment fees, redemption premiums and break costs from any QDS, such other income directly attributable to QDS, and any amount payable from any Islamic debt securities that are QDS (collectively 'QDS income') and that is derived by a non-resident person, subject to qualifying conditions

— concessionary tax rate of 10 percent on QDS income derived by companies and bodies of persons, subject to qualifying conditions.

The tax exemption and concessionary tax rate will apply to QDS issued until 31 December 2018.

In addition, current Singapore tax legislation provides for tax exemption on interest, discount, prepayment fee, redemption premium and break cost from any debt securities, such other income directly attributable to debt securities and any amount payable from any Islamic debt securities, where the income is derived from Singapore by any individual, provided such income is not derived through a partnership in Singapore or from carrying on a trade, business or profession.

Deductibility of interest

Interest expense is tax-deductible where it is incurred on capital employed in acquiring income. Therefore, interest is deductible where it is incurred in connection with amounts borrowed and used as working capital or to fund capital expenditure used to generate income for the company. As such, interest incurred on borrowings to acquire either shares of a company or the trade and assets of a company should be tax-deductible. See, however, comments later in the report.

While there are no thin capitalization rules in Singapore, certain restrictions may limit the deductibility of interest.

The IRAS takes the view that each investment asset (including an intercompany advance) constitutes a separate source of income. Therefore, to the extent that the investment or asset has never produced income (i.e. non-income-producing investments and assets), any interest expense that is incurred in funding or financing the asset is not deductible for income tax purposes.

Where it is not possible to trace the usage of interest-bearing funds, the IRAS uses an asset-based formula to attribute the interest expense to the non-income-producing investment. Based on this formula, the interest attributable to the non-income-producing investment is disallowed for tax purposes. Non-income-producing investments include interest-free loans and equity investments that have never yielded dividend income.

Withholding tax on debt

Interest paid to any person who is not a tax resident of Singapore is subject to Singapore WHT at the rate of 15 percent of the gross payment. The WHT applies provided that the interest is not derived by the non-resident person from any trade, business, profession or vocation carried on or exercised by the non-resident in Singapore and that the interest is not effectively connected with any permanent establishment of that non-resident person in Singapore. The rate of WHT may be reduced by a tax treaty between Singapore and the country of the recipient.

Where interest is payable on a loan for a purpose that promotes or enhances economic and technological development in Singapore, an application may be made to the Minister for Finance for the payment of the interest to be exempted from WHT.

Checklist for debt funding

— Consider whether the level of non-income-producing assets limits the deduction of interest expenses.

— Consider whether WHT of 15 percent on interest may be reduced or eliminated by structuring loans from the relevant treaty country.

Islamic financing

Although Islamic finance has existed for several decades, this alternative has only recently attracted global attention.

The basic principle of Islamic banking is the prohibition or absence of interest. Given the nature and structure of Islamic financial products, they tend to attract more tax than conventional financial products. Transactions that involve financing of real estate in compliance with Islamic law would typically be exposed to stamp duties twice under Singapore tax law because there would be two transfers of legal title to the property asset.

To encourage the growth of Islamic financing, the following tax concessions have been introduced:

— Where there are double stamp duties for qualifying Islamic financing arrangements involving real estate, the taxpayer may apply for stamp duty remission, subject to prescribed conditions.

— The concessionary tax treatment under the QDS scheme is extended to Islamic debt securities. Under this treatment, any amount payable from any Islamic debt securities that are QDS and issued from 1 January 2005 to 31 December 2018 may be tax-exempt or taxed at 10 percent, subject to certain conditions.

— Any amount payable on Islamic debt securities derived by individuals on and after 1 January 2005 is exempt from Singapore tax, provided the income is not derived through a partnership in Singapore or from carrying on a trade, business or profession.

Equity

Incidental costs of raising equity finance, such as legal and professional fees, are normally regarded as capital in nature. As such, they are not tax-deductible unless they qualify for double tax deduction under the M&A scheme outlined in the earlier section.

The registration fee for a limited liability company is SGD300, regardless of the size or currency of the share capital. A Singapore company is no longer required to have an authorized capital.

There is no WHT on dividends paid by a Singapore company. Dividends paid by a Singapore-resident company are tax-exempt in Singapore.

Profits arising from share swap transactions are not normally subject to income tax under restructuring arrangements. Stamp duty is generally payable on a share swap transaction unless the conditions for intragroup exemption (discussed earlier) are satisfied.

Hybrids

A commonly used hybrid is the redeemable preference share (RPS). An RPS is generally treated as a form of equity for tax purposes even though certain RPSs may be treated as debt instruments for accounting purposes. The use of an RPS allows for flexibility of redemption, which is generally regarded as a repayment of capital. The IRAS has also issued guidelines to determine the characterization of hybrid instruments and accordingly the tax treatment. As the characterization would be determined based on facts and circumstances and a combination of factors, an advance ruling may be sought from the IRAS to obtain certainty before issuing the hybrid instrument.

Discounted securities

For tax purposes, the issuer of discounted securities can claim deduction for the discount as a borrowing cost. However, the discount is only allowed as a deduction when it is incurred on the maturity or redemption of the debt securities.

Deferred settlement

The buyer is not allowed a deduction for deferred consideration for an acquisition because the payment is regarded as capital in nature. This treatment applies even where the deferred consideration can only be determined at a later date on the basis of the post-acquisition performance of the business.

Depending on the seller's tax status, the seller is taxed on deferred consideration where the gains from the sale of the business or shares are regarded as trading gains.

Other considerations

Concerns of the seller

Where the seller is likely to be taxed on gains arising from the transfer, it is more tax-efficient for the seller to realize part of the value of their investment by the payment of a pre-sale dividend, which is tax-exempt.

Amalgamations

Under the Companies Act (Cap. 50), Singapore provides for an effective and efficient statutory form of merger and amalgamation process, which allows:

— two or more companies to merge and continue as one company without involving the courts, provided the companies are solvent

— a parent and a wholly owned subsidiary to merge or two or more wholly owned subsidiaries to merge (i.e. a short-form amalgamation).

Section 34C of the ITA governs the tax treatment for amalgamating companies in a qualifying corporate amalgamation that takes effect on and after 22 January 2009.

The section only applies to a 'qualifying amalgamation', which is defined as:

— any amalgamation of companies where the notice under section 215F of the Companies Act (Cap. 50) or a certificate of approval under section 14A of the Banking Act (Cap. 19) is issued on or after 22 January 2009

— other amalgamations of companies approved by the Minister (or such person as he may appoint).

In a qualifying amalgamation, the amalgamated company must elect in writing within 90 days from the date of the amalgamation to avail itself of the tax treatment for a qualifying amalgamation. On election, the trade and business of all the amalgamating companies is treated as carried on in Singapore by the amalgamated company from the date of amalgamation.

The following tax treatment applies to qualifying corporate amalgamations (as provided in the ITA, regulations and/or IRAS guidelines):

— An amalgamated company cannot claim tax deduction on interest and borrowing costs incurred on any borrowings made by an amalgamating company to acquire shares in another amalgamating company where the two companies concerned subsequently amalgamate.

— Where the property transferred is trading stock for both the amalgamated and amalgamating companies, the amalgamated company is deemed to have taken over the trading stock of the amalgamating company at net book value. Consequently, the cost of the stock claimable by the amalgamated company in computing its gains is the net book value of the stock taken over at the point of amalgamation.

— Alternatively, the amalgamating company can elect to take over the stock at fair value. In this case, the amalgamated company can fully deduct the fair value and the amalgamating company is taxed on the difference between fair value and net book value.

— Where the property transferred is trading stock of the amalgamating company but a capital asset to the amalgamated company, the amalgamating company is regarded as having sold the property at the open market value on the date of amalgamation.

— Where the property transferred is not a trading stock of the amalgamating company but is trading stock of the amalgamated company, the purchase consideration of the amalgamated company is taken as the market value on the date of amalgamation or actual amount paid, whichever is the lower.

— Where the amalgamating company ceases to exist on amalgamation, the amalgamated company can deduct the impairment loss or the amount of bad debts written off in respect of the trade debts taken over (from the amalgamating company). Similarly, where the amalgamating company has been allowed a deduction in respect of any debt written off or impairment loss, any such debt recovered subsequently is taxable for the amalgamated company.

— Where capital allowances have been made to properties transferred from the amalgamating company to the amalgamated company, the capital allowances continue to be made to the amalgamated company as if no transfer had taken place.

— Where the amalgamating company has unused capital allowance, donations or losses at the date of amalgamation, the amalgamated company may take over those items and use them against its assessable income, provided the amalgamating company was carrying on a trade up to the date of amalgamation and the amalgamated company continues to carry on the same trade or business as that carried on by the amalgamating company immediately before the amalgamation.

— Where any of the amalgamating companies have opted to adopt Financial Reporting Standards (FRS) 39 for tax purposes, the amalgamated company cannot opt out of applying FRS 39. Where the amalgamating company has opted out of FRS 39 for tax purposes, the amalgamated company can maintain the same status unless it opts to adopt the FRS 39 tax treatment.

— FRS 109 — *Financial Instrument* replaces FRS 39 for financial periods beginning on or after 1 January 2018. Once a company adopts FRS 109 for accounting purpose, FRS 109 tax treatment would be the only tax treatment (i.e. there will be no opting out or 'pre-FRS 39/109' tax treatment).

— Where any of the amalgamating companies ceases to exist on amalgamation, the amalgamated company assumes all liabilities and obligations of the amalgamating companies.

Group relief/consolidation

Subject to meeting the requisite conditions, qualifying group companies may transfer current YA unabsorbed capital allowances, current-year losses and unabsorbed approved donations to other group member companies. For the purpose of the group relief system, the primary test (among other requirements) is that a group must consist of a Singapore-incorporated company and its Singapore-incorporated group members. Two Singapore-incorporated companies are members of the same group where:

— at least 75 percent of the ordinary share capital in one company is beneficially held, directly or indirectly, by the other

— at least 75 percent of the ordinary share capital in each of the two companies is beneficially held, directly or indirectly, by a third Singapore-incorporated company (i.e. the relevant holding company).

Under the M&A scheme, the M&A allowance and double tax deduction on transaction costs are not available for transfer under the group relief system.

Transfer pricing

Legislation formalizing existing transfer pricing compliance and documentation requirements and providing for new penalties and surcharges on transfer pricing adjustments made by IRAS, was passed in October 2017. IRAS has also issued local transfer pricing guidelines, which are expected to be updated in early 2018.

IRAS has adopted the arm's length principle as the standard and expects all related-party transactions to be conducted on an arm's length basis. Transfer pricing documentation should

be prepared and maintained on a contemporaneous basis for both domestic and cross-border related party transactions unless specifically exempted.

To facilitate compliance with the arm's length principle and reduce compliance cost, IRAS has introduced indicative margins for related-party loans below SGD15 million obtained or provided from 1 January 2017. Where a related domestic loan is provided by a taxpayer that is not in the business of borrowing and lending, IRAS will apply interest restriction in place of the arm's length methodology. This is done by limiting the taxpayer's claim for any interest expense to the interest charged on such loan. IRAS requires all cross-border loans to be made on arm's length terms.

Dual residency

There is no advantage in establishing a dual resident company because the IRAS does not recognize such status.

Foreign investments of a local target company

As Singapore has adopted a territorial basis of taxation, tax is levied on income accruing in or derived from Singapore. Foreign-sourced income is not taxable in Singapore unless it is received or deemed to be received in Singapore under local tax legislation. Hence, dividend income from foreign investments is not taxed in Singapore unless it is remitted or deemed remitted to Singapore.

An income tax exemption is still generally granted to all persons resident in Singapore on their specified foreign income — namely, dividends, branch profits and service income received in Singapore on or after 1 June 2003 — provided the following conditions are met:

— In the year the income is received in Singapore, the headline tax rate of the foreign jurisdiction from which the income is received is at least 15 percent.

— The specified foreign income has been subjected to tax in the foreign jurisdiction from which it was received.

— The IRAS is satisfied that the exemption would be beneficial to the Singapore-resident person.

Where the specified foreign income was exempted from overseas tax in the relevant foreign jurisdiction by virtue of a tax incentive awarded for substantive business operations undertaken in the foreign jurisdiction, the income is deemed to have been taxed in that foreign jurisdiction.

Where the above conditions are not met, the specified foreign income is taxed on remittance under normal tax rules. Where the specified foreign income is also subject to tax in the foreign jurisdiction, double taxation may be relieved through Singapore's unilateral tax credit system and through its many bilateral tax treaties.

With effect from YA 2012, foreign tax credits can be claimed for foreign tax suffered under a foreign tax credit pooling system, which is based on the lower of the aggregate foreign taxes paid or the aggregate Singapore tax payable in the pooled foreign income.

Comparison of asset and share purchases

Advantages of asset purchases

— The purchase price of qualifying assets (or a proportion) may be depreciated for tax purposes in the form of capital allowances.

— Liabilities and business risks of the seller company are not transferred.

— Possible to acquire only certain parts of a business.

— Interest is deductible where incurred to fund the acquisition of plant, equipment and other assets that will be used in the trade or business.

Disadvantages of asset purchases

— Possible clawback of capital allowances claimed by the seller in the form of a balancing charge.

— Higher stamp duties on the transfer of real or immovable properties (other than cases involving equity interests in residential PHEs where ACD applies).

— Benefits of any losses or unused tax attributes remain in the target company.

Advantages of share purchases

— No balancing charges or clawbacks for the seller.

— Buyer may be able to use and benefit from tax losses, other unused tax attributes and tax incentives of the company acquired, subject to conditions.

— Lower stamp duties payable on the transfer of shares, compared with real or immovable property (other than cases involving equity interests in residential PHEs where ACD applies).

— Eligible for M&A allowance and stamp duty relief, subject to conditions.

Disadvantages of share purchases

— Buyer may acquire historical tax and other liabilities.

— No deduction or depreciation allowances (capital allowances) are available for the purchase cost of shares.

— Interest incurred to fund the acquisition of shares could be restricted.

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Thailand

Introduction

Thailand's government is a constitutional monarchy. Executive powers are exercised by the Prime Minister and the Council of Ministers, legislative powers by Parliament, and judicial powers by a judicial system composed of the Courts of First Instance, Court of Appeals and Supreme Court.

The principal taxation law of Thailand is the Revenue Code 1938. Royal decrees, ministerial regulations, ministerial notifications and Board of Taxation directives and rulings supplement the Code. The Director-General of Revenue administers the country's tax legislation.

A separate income tax law applies to companies involved in the exploitation of naturally occurring Thai oil and gas assets.

Companies that receive Board of Investment (BOI) promotion may obtain special taxation incentives for a number of years from the commencement of operations.

Recent developments

Recently, Thailand has seen significant developments in both domestically and internationally. Among other things, Thailand has

— joined the inclusive framework on base erosion and profit shifting (BEPS)

— implemented a national e-payment scheme to move tax collection to an online platform

— reformed corporate income tax and value added tax (VAT) for e-commerce businesses.

Thailand joined the inclusive framework on BEPS in June 2017 and plans implement the international standards on exchange of information and BEPS measures. The Thai Revenue Department is currently considering which of the OECD and EU requirements it will adopt.

The national e-payment scheme was announced in 2017, which is intended to increase the efficiency of Thailand's payment infrastructure. The scheme includes the development and implementation of the e-tax system for reducing use and storage of paper.

Thailand ratified new tax treaties with Singapore and India, which entered into force as of from 1 January 2017. Thailand also entered into a tax treaty with Cambodia on 7 September 2017, with effect from 1 January 2018.

Asset purchase or share purchase

An acquisition in Thailand generally takes the form of a purchase of the shares of a company, as opposed to acquisition of the target's business and assets.

From a tax perspective, the likely recapture of capital allowances (i.e. taxable gain on sale of assets) is likely to make asset acquisitions less attractive for the seller. However, the benefits of asset acquisitions for the buyer should not be ignored, particularly given the potential step-up in the tax cost base of the assets to market value and the fact that purchased goodwill is tax-deductible generally over 10 years. Some of the tax considerations relevant to each method are discussed below. The relative advantages are summarized at the end of this report.

Purchase of assets

A purchase of assets usually results in an increase in the tax cost base of those assets to the acquisition cost. In addition, historical tax liabilities generally remain with the company and are not transferred with the assets.

However, the restrictions on foreign investment imposed under the Foreign Business Act may limit the ability to acquire the assets directly without setting up a Thai subsidiary and obtaining the relevant approvals (if available) or acquiring the assets through a majority Thai-owned structure.

Purchase price

For tax purposes, it is necessary to apportion the total consideration among the assets acquired. It is generally advisable for the purchase agreement to specify the allocation, which is normally acceptable for tax purposes provided it is commercially justifiable.

Goodwill

Intangible assets, including goodwill, formulae, trademarks, business licenses, patents, copyright and any other rights are generally depreciable for tax purposes at the rate of 10 percent per year, or if the period of use is limited, 100 percent divided by the years of useful life.

Depreciation

A company is entitled to depreciate capital expenditure by using its acquisition cost base. Depreciation commences from the date of acquisition and must be apportioned if the asset is acquired partway through a fiscal year.

The company may adopt its own depreciation method; however, the useful life of the asset must not be shorter than that prescribed by the Thai Revenue Code.

Generally, the prescribed straight-line depreciation rates are as follows:

— machinery and related equipment — 20 percent

— permanent buildings — 5 percent

— temporary buildings — 100 percent

— depletable natural resources — 5 percent

— goodwill, formulae, trademarks, business licenses, patents, copyrights and any other rights — 10 percent or, if the period of use is limited — 100 percent divided by the years of useful life

— computer software, equipment and hardware — 33.33 percent

— other assets (excluding land or inventory) — 20 percent.

Tax attributes

Tax losses are not transferred on an asset acquisition. They remain with the original company in which they were derived. However, it may be possible for certain tax privileges obtained under Thailand's BOI to be transferred to the acquiring company with the related assets.

Value added tax

VAT is payable by suppliers of taxable goods and in respect of services rendered in Thailand or performed offshore and used in Thailand.

VAT is currently levied at the standard rate of 7 percent on the taxable base for the goods or services rendered. Certain supplies are exempt from VAT or zero-rated.

Transfer taxes

A number of documents and transactions are subject to stamp duty in Thailand. Stamp duty is capped for certain instruments. Stamp duty is applicable at the following rates, depending on the circumstances:

— lease of land or building — 0.1 percent of the rent

— transfer of share, debenture or bond — 0.1 percent of the greater of the paid-up value of share and the transfer price

— hire of work agreement — 0.1 percent of the contract value

— monetary loan — 0.05 percent of the loan, with a cap at 10,000 Thai baht (THB).

Stamp duty may not be applicable in certain situations, or an exemption may be available. For example, stamp duty is not payable on share transfer documents in respect of securities listed in Thailand. In addition, any transfer executed offshore should not be subject to stamp duty until the transfer document is brought back into Thailand.

In certain circumstances, the liability to remit the stamp duty to the revenue office may rest with the buyer, such as when a non-resident provides services to a Thai recipient.

The acquisition of land also gives rise to a transfer fee on the transfer of the property (generally split equally between buyer and seller). The fee is equal to 2 percent of the Land Department's assessed value.

Purchase of shares

There is no mechanism in Thailand's tax legislation for the purchase price of a target company's shares to be pushed down to increase the tax base cost of that company's underlying assets.

Tax indemnities and warranties

In a share acquisition, the buyer is taking over the target company together with all related liabilities, including contingent liabilities. Therefore, the buyer normally requires more extensive indemnities and warranties than in the case of an asset acquisition. Where significant sums are at issue, it is customary for the buyer to initiate a due diligence exercise, which normally incorporates a review of the target's tax affairs.

Tax losses

Tax losses incurred by a legal corporation may be carried forward for a maximum of 5 consecutive accounting periods and set off against profits of any nature (losses cannot be carried back). Tax losses are not foregone on a change in the company's ownership or business; any carried forward losses should survive acquisition.

Thailand has no separate capital gains tax. All losses are of a revenue nature and can be used to offset any type of income earned in the future. A company's brought forward tax losses cannot be used to offset profits of other companies through group relief.

Pre-sale dividend

The seller may prefer to realize part of the value of their investment as income by means of a pre-sale dividend. The rationale here is that the dividend may be partially or fully exempt and would reduce any gain on the disposal, which may be fully assessable.

Transfer taxes

The transfer of shares in a Thai company is subject to stamp duty in Thailand at the rate of 0.1 percent of the greater of the paid-up value of the shares and the nominal value. The transferor has the prima facie liability to pay the stamp duty, but where the transaction is executed offshore, the liability rests with the first holder of the share transfer document in Thailand.

Choice of acquisition vehicle

The most common form of entity in Thailand is the limited company. In general, foreign companies prefer to operate as limited companies rather than as branch offices in order to limit liabilities. Thailand does not generally recognize flow-through vehicles, such as trusts.

Local holding company

A Thai holding company may be used. However, this option may not be attractive as no grouping rules are available to allow for the offset of any losses in a group with income from other entities.

A Thai holding company may also be relevant where the foreign ownership restrictions would not allow majority foreign ownership. A Thai private limited company may be wholly owned by foreign parties. However, for certain business activities reserved for Thai nationals, foreign participation is generally allowed up to 49 percent.

Dividends paid from the underlying company should be exempt from tax for the holding company, provided it holds at least 25 percent of the voting shares in the company without cross-shareholding and holds the shares for at least 3 months both before and after the payment of the dividend.

Foreign parent company

Because of the restrictions on foreign ownership (particularly land ownership), a foreign company cannot hold assets directly. In certain circumstances, a Thai limited company may be wholly owned by foreign parties. However, as noted previously, certain business activities are reserved for Thai nationals and foreign participation is limited to 49 percent.

Thailand imposes withholding taxes (WHT) on dividends (10 percent on all dividends paid to foreign companies) and interest (10 or 15 percent). In addition, foreign parties may be subject to WHT in Thailand on disposal of any local assets. A Thai buyer is required to withhold from the sale proceeds an amount equal to 15 percent of the gain derived by the foreign entity on disposal.

Non-resident intermediate holding company

Where the foreign country taxes foreign capital gains and dividends, it is not uncommon for a foreign intermediate holding company to be used to defer WHT. Potential tax benefits may also be attained on disposal; tax treaties with certain countries also provide for an exemption from local WHT on any gain derived on disposal.

Local branch

A company incorporated under foreign laws may establish a branch office to do business in Thailand.

As a condition for approval of an alien business license for a branch of a foreign corporation, minimum capital of THB3 million must be brought into Thailand.

For tax purposes, the branch of the foreign company should constitute part of the same legal entity as its head office. The branch is taxable in Thailand on net profits attributable to its business in Thailand. Any gains derived from the sale of branch assets are prima facie subject to tax in Thailand.

While a foreign corporation is not taxable in Thailand on foreign-sourced income, the same is not always true for a branch. Fees paid by a foreign entity to the branch in respect of work performed by the branch are subject to Thai tax.

Joint venture

Although an unincorporated joint venture is not yet recognized under the Thai Civil and Commercial Code, income from a joint venture is subject to corporate tax under the Thai Revenue Code, which classifies a joint venture as a single tax entity.

Choice of acquisition funding

A buyer using a Thai acquisition vehicle to carry out an acquisition for cash needs to decide whether to fund the vehicle with debt, equity or a hybrid instrument that combines the characteristics of both. The principles underlying these approaches are discussed below.

Debt

The advantage of debt is the potential tax-deductibility of interest and the ease of repatriating the investment contribution through repayment of debt principal. By contrast, the payment of dividends is not deductible and returns of capital can be administratively difficult and time-consuming.

Because of the lack of grouping rules in Thailand, any debt held at the Thai company level should be held in the company earning the taxable profits to ensure tax-deductibility.

Although there are no debt-to-equity restrictions for income tax purposes, other regulatory requirements may require a certain level of equity (e.g., the BOI rules generally require a 3:1 debt-to-equity ratio).

Deductibility of interest

There is no formal definition of 'interest' in Thai tax law. Interest generally includes interest on bonds, deposits, debentures, bills and secured/unsecured loans.

Generally, interest expenses incurred on funds borrowed for the purpose of the business are deductible and include borrowings to fund share acquisitions and for the payment of dividends. Generally, a company's accounting treatment of interest is followed for tax purposes (i.e. generally on an accruals basis, even where the interest is not actually paid for an extended period of time).

Although Thailand has no thin capitalization provisions, the Thai Revenue Department may apply the transfer pricing rules to restrict interest deductibility where the interest rate charged is higher than an arm's length rate.

Withholding tax on debt and methods to reduce or eliminate it

Interest payments offshore are subject to WHT at the rate of 15 percent of the gross amount. The rate may be reduced to 10 percent under an applicable tax treaty where the interest is paid to a bank or financial institution.

Although a deduction is provided in Thailand for interest on an accruals basis, WHT must be remitted to the Thai Revenue Department on payment. As such, timing benefits may be available where the debt is with an entity resident in a country that would only seek to tax the interest income on a cash basis.

Checklist for debt funding

— Interest payments offshore are subject to WHT at 15 percent of the gross amount.

— Due to the lack of thin capitalization provisions and the 28 percent effective tax rate on the repatriation of profits offshore by payment of dividends, debt funding may reduce the effective tax rate where the level of profits permits.

Equity

A buyer may use equity to fund its acquisition, and foreign investors may be required to use a certain debt-to-equity ratio in order to obtain certain BOI approvals.

There is no minimum level of capitalization. However, a limited company's capital must be sufficient to accomplish its objectives. In addition, all shares must be subscribed, and at least 25 percent of the shares must be paid-up.

Using only equity funding may not be attractive because dividends are not deductible for Thai tax purposes, and the effective tax rate on the repatriation of profits offshore from Thailand is 28 percent (20 percent corporate tax plus 10 percent WHT). In addition, because of the difficulty in achieving a return of capital, it may be difficult for the investor to recover the funds it has injected.

Despite this lack of flexibility, equity may be more appropriate than debt in certain circumstances, such as where the target is loss-making or where no immediate tax relief is available for interest payments.

Thailand allows for an entire business transfer, under which the business and liabilities of one company are transferred to another company as an asset sale. The Thai Revenue Code allows the transaction to be accounted for at net book value for corporate income tax purposes (i.e. no taxable gain or loss), but the consideration paid can be at market value. Further, the Thai Revenue Code allows the asset transfer to be VAT-free. One of the conditions of the entire business transfer is that the transferor must start liquidation procedures in the year of the transfer.

Thailand also has an amalgamation process whereby two companies can merge to form a new company. This transaction is free from Thai corporate income tax, but any tax losses in either of the original companies are lost. Both original companies are dissolved as a part of the amalgamation.

Hybrids

Generally, hybrid securities, including redeemable preference shares, are not available.

Discounted securities

The tax treatment of securities issued at a discount to third parties generally follows the accounting treatment (i.e. the discount accrues over the life of the security). The discount should constitute interest for WHT purposes.

Deferred settlement

The tax legislation is not clear on the treatment of deferred settlements. Each case should be considered on its facts.

Other considerations

Concerns of the seller

The seller may prefer to realize part of the value of their investment as income by means of a pre-sale dividend. The rationale here is that the dividend may be partially or fully exempt and would reduce any gain on the disposal, which may be fully assessable.

Where the seller is a non-resident of Thailand, the seller may prefer to dispose of the shares in a Thai resident company to another non-resident company in order to avoid any potential WHT in Thailand.

Company law and accounting

Under Thai law, there are two types of companies: limited companies and public limited companies. Incorporation and operation of limited companies is governed by the Civil and Commercial Code, while public limited companies are governed by the Public Limited Company Act 1992.

Additionally, the Foreign Business Act 1999 should be considered as the most important law for foreign investors. This legislation specifies the foreign ownership restrictions on certain activities that may require the permission from the authorities prior to engaging in the business.

The basic concept of the limited company is similar to a western corporation. A limited company is a legal person with a registered capital that should be reasonably sufficient to achieve the company's objectives. The minimum number of shareholders required at all times is three. The liability of shareholders is limited to the fully paid-up amount of shares held, but the minimum payment for each share is only 25 percent of par value. In addition, non-voting rights are not permitted for either common or preference shares. The company may be wholly owned by a foreign party, provided

the business is not reserved for Thai nationals by law, in which case foreign participation is only allowed up to 49 percent.

Although the procedure for incorporating a public limited company is not much different than it is for a limited company, the governmental regulatory requirement is more complex because a public limited company is allowed to sell its shares to the public. A limited company can be converted to a public limited company according to the relevant regulations. The advantage is that a public limited company may offer both its shares and debentures to the public. A public limited company wishing to list its shares on the Stock Exchange of Thailand (SET) must obtain the approval from SET and the Securities and Exchange Commission of Thailand.

In Thailand, all new standards issued by the Federation of Accounting Professions are committed to be in line with International Financial Report Standards (IFRS), and discussions are being held for future convergence toward IFRS for companies listed in the Stock Exchange of Thailand. A non-listed company in Thailand can use either Thai Accounting Standards (TAS) or Thai Accounting Standards for Non-Publicly Accountable Entities (NPAE).

Audited financial statements of legal entities (including companies, branches and representative and regional offices) must be certified by an authorized auditor and lodged with the Thai Revenue Department and the Commercial Registrar for each accounting year. Documents may be prepared in any language, provided a Thai translation is attached.

A newly established company should close its accounts within 12 months from the date of registration. The accounting year is generally the calendar year. A company wishing to change its accounting period must obtain a written approval of the Director-General of the Thai Revenue Department.

Group relief/consolidation

Thailand does not provide for group relief or tax consolidation for corporate tax purposes.

Transfer pricing

After public consultation and approval from the council of state, the Cabinet of Thailand approved a new draft transfer pricing law on 3 January 2018.

These provisions aim to prevent tax evasion through transfer prices on transactions between related parties, provide standard guidelines for how to determine a market price that is in line with international standards, and to achieve fairness in taxation.

Based on the current draft law, the minimum income threshold eligible for exemption from preparing a report of related party transaction will be at least THB30 million. The Thai parliament is reviewing the draft law, and it is expected to be made public soon.

Dual residency

There are no real advantages in seeking to establish a dual resident company.

Foreign investments of a local target company

A Thai legal company is taxed on all foreign income, including foreign dividends, interest and gains derived from foreign investments. Thailand does not impose controlled foreign company or similar provisions that seek to tax the income earned offshore.

In addition, the foreign dividends may be exempt from Thai corporate tax where the Thai company holds at least 25 percent of the voting shares of the foreign company (for a period of at least 6 months prior to receipt of the dividend) and the underlying profits from which the dividends were paid were subject to tax in the foreign country at a rate of at least 15 percent.

Comparison of asset and share purchases

Advantages of asset purchases

— The purchase price of the relevant assets, including goodwill, may be depreciated for tax purposes.

— Liabilities and business risks of the seller company are not transferred to the buyer.

— Possible to acquire only parts of the business.

— Interest to fund the acquisition of assets should be tax-deductible.

Disadvantages of asset purchases

— Possibility of taxable gains derived from the assets for the seller.

— Benefits of tax losses remain in the target company.

Advantages of share purchases

— Seller should not be subject to any taxable gains on the underlying assets.

— Buyer may benefit from any unused tax losses despite the change in ownership or possible change in the loss company's business.

— Other tax benefits may also be acquired, such as deferred tax assets and tax credits.

Disadvantages of share purchases

— Buyer acquires historical tax cost-base. There is no mechanism to reset the tax cost of the assets to market value for tax purposes.

Thailand — Withholding tax rates

All payers of certain types of assessable income are required to deduct tax at source from payments of such income to overseas resident individuals and corporations at the following rates.

Assessable income	WHT rate (percent)
Dividends	10
Interest	15[1]
Royalties	15[2]
Gains from sale of shares within Thailand	15[3]
Distribution of profits	10
Management fees, technical fees and other income subject to withholding under Section 70 of the Revenue Code	15[4]

Source: Sections 50 and 70 of the Thai Revenue Code

Notes:

1. A 10 percent rate applies to interest paid to foreign bank or financial institutions (including insurance companies) that are resident in a country having a tax treaty with Thailand.
2. Lower rates of 5, 8 or 10 percent exist for royalties paid for the use of copyright of literary, artistic or scientific work or for the use of industrial, commercial or scientific equipment to residents of certain countries with tax treaties with Thailand.
3. Certain gains are tax-free under the terms of certain treaties.
4. Under Thailand's tax treaties, provided such income is not excluded from the meaning of 'business profits' or not specifically treated as a royalty, entities without a Thai permanent establishment are not subject to Thai tax on such income. Accordingly, they are not subject to Thai WHT.

As of January 2018, Thailand has signed tax treaties with 61 countries and jurisdictions. The following WHT rates apply to recipient countries/jurisdictions that do not have a permanent establishment or fixed base in Thailand.

Source: Revenue Department of Thailand website, January 2018.

Country/Jurisdiction	Dividends (percent)	Interest (percent)	Royalties (percent)
Armenia	10	10/15[1]	15
Australia	10	10/15[1]	15
Austria	10	10/15[1]	15
Bahrain	10	10/15[1]	15
Bangladesh	10	10/15[1]	15
Belgium	10	10/15[1]	5/15[2]
Bulgaria	10	10/15[1]	5/15[10]
Cambodia	10	10/15[1]	10[26]
Canada	10	10/15[1]	5/15[3]
Chile	10	10/15[1]	10/15[14]
China (People's Rep.)	10	10/15[1]	15
Cyprus	10	10/15[18]	5/10/15[11]
Czech Republic	10	10/15[1]	5/10/15[4]
Denmark	10	10/15[1]	5/15[2]
Estonia	10	10	8/10[23]
Finland	10	10/15[1]	15

Country/Jurisdiction	Dividends (percent)	Interest (percent)	Royalties (percent)
France	10	3/10/15[5]	0/5/15[6]
Germany	10	10/15[1]	5/15[2]
Hong Kong (SAR)	10	10/15[19]	5/10/15[4]
Hungary	10	10/15[1]	15
India	10	10[27]	10[28]
Indonesia	10	10/15[1]	15
Ireland	10	10/15[19]	5/10/15[24]
Israel	10	10/15[1]	5/15[3]
Italy	10	10/15[1]	5/15[2]
Japan	10	10/15[1]	15
Korea (Rep.)	10	10/15[19]	5/10/15[13]
Kuwait	10	10/15[1]	15
Laos	10	10/15[1]	15
Luxembourg	10	10/15[1]	15
Malaysia	10	10/15[1]	15
Mauritius	10	10/15[1]	5/15[10]
Myanmar	10	10	5/10/15[15]
Nepal	10	10/15[1]	15
Netherlands	10	10/15[1]	5/15[2]
New Zealand	10	10/15[19]	10/15[7]
Norway	10	10/15[1]	5/10/15[12]
Oman	10	10/15[1]	15
Pakistan	10	10/15[1]	0/10/15[16]
Philippines	10	10/15[21]	15
Poland	10	10/15[1]	0/5/15[20]
Romania	10	10/15[1]	15
Russia	10	10/15[1]	15
Seychelles	10	10/15[1]	15
Singapore	10	10/15[29]	5/8/10[30]
Slovenia	10	10/15[1]	10/15[22]
South Africa	10	10/15[1]	15
Spain	10	10/15[1]	5/8/15[8]
Sri Lanka	10	10/15[1]	15
Sweden	10	10/15[1]	15
Switzerland	10	10/15[1]	5/10/15[4]
Taiwan	5/10[17]	10/15[1]	10
Tajikistan	10	10	5/10[25]
Turkey	10	10/15[1]	15
Ukraine	10	10/15[1]	15
United Arab Emirates	10	10/15[1]	15
United Kingdom	10	10/15[1]	5/15[2]
United States	10	10/15[19]	5/8/15[9]
Uzbekistan	10	10/15[1]	15
Vietnam	10	10/15[1]	15

Notes:

1 10 percent applies to a recipient that is a bank or financial institution (including an insurance company); 15 percent for other interest payments.

2 5 percent for the use of or the right to use any copyright of literary, artistic, or scientific work; 15 percent for other royalties.

3 5 percent for production or reproduction of any literary, dramatic, musical, or artistic work (but not including royalties in respect of motion picture films and works on film or videotape for use in connection with television broadcasting);15 percent for other royalties.

4 5 percent for alienation or the right to use any copyright of literary, artistic or scientific work excluding cinematograph films or tapes used for radio or television broadcasting; 10 percent for alienation of any patent, trademark, design or model plan, secret formula, or process;15 percent rate for other royalties.

5 3 percent for interest paid on loans or credits granted for 4 years or more with the participation of a financing public institution to a statutory body or to an enterprise in relation to the sale of any equipment or to the survey, installation or supply of industrial, commercial or scientific premises, and public works; 10 percent applies to a recipient that is financial institution; 15 percent for other interest payment.

6 0 percent for payment in respect of films or tapes (payable to a contracting state or state-owned company); 5 percent for the use of or the right to use any copyright of literary, artistic or scientific work; 15 percent for other royalties.

7 10 percent for the use of or the right to use any copyright, any industrial, commercial or scientific equipment, any motion picture film or film or videotape or any other recording for use in connection with television, or tape or any other recording in connection with radio broadcasting; the reception of, or the right to receive, visual images or sounds or both and the use in connection with television or radio broadcasting, visual images or sounds, or both, transmitted by satellite or cable, optic fiber or similar technology; 15 percent for other royalties.

8 5 percent for the use of or the right to use any copyright of literary, dramatic, musical, artistic or scientific work excluding cinematograph films or films or tapes used for radio or television broadcasting; 8 percent for the use of or the right to use industrial, commercial or scientific equipment;15 percent for other royalties.

9 5 percent for the use of or the right to use any copyright of literary, artistic or scientific work, including software, and motion pictures and works on film, tapes or other means of reproduction for use in connection with radio or television broadcasting; 8 percent for the use of or the right to use industrial, commercial or scientific equipment; 15 percent for other royalties.

10 5 percent for the use of or the right to use any copyright of literary, dramatic musical, artistic or scientific work excluding cinematograph films or films or tapes used for radio or television broadcasting; 15 percent for other royalties.

11 5 percent for the use of or the right to use any copyright of literary, dramatic, musical, artistic or scientific work including software, cinematograph films or tapes used for radio or television broadcasting; 10 percent for the use of or the right to use industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific equipment or information concerning industrial, commercial or scientific experience; 15 percent for other royalties

12 5 percent for the use of or the right to use any copyright of literary, artistic or scientific work; 10 percent for the use of industrial, commercial, or scientific equipment; 15 percent for other royalties.

13 5 percent for the use of or the right to use any copyright of literary, artistic or scientific work including software, and motion pictures and works on films, tapes or other means of reproduction for use in connection with radio or television broadcasting; 10 percent for the use of or the right to use any patent, trademark, design or model, plan, secret formula or process; 15 percent for other royalties.

14 10 percent for the use of or the right to use any copyright of literary, artistic or scientific works and any industrial, commercial or scientific equipment;15 percent for other royalties

15 5 percent for the use of or right to use any copyright of literary, artistic or scientific work; 10 percent rate for the consideration for any services of a managerial or consultancy nature, or for information concerning industrial, commercial or scientific experience; 15 percent for other royalties.

16 0 percent for films or tapes (payable to a contracting state or state-owned company); 10 percent for the use of or the

right to use any copyright of literary, artistic or scientific work; 15 percent for other royalties.

17 5 percent for dividend if the beneficial owner directly holds at least 25 percent of the capital of the company paying dividend; 10 percent for other dividend payments.

18 10 percent for interest received by a financial institution (including an insurance company), or paid by in connection with the sale on credit of any industrial, commercial or scientific equipment or the sale on credit of any merchandise by one enterprise to another enterprise; 15 percent for other interest.

19 10 percent for interest paid to financial institution (including insurance company) or with respect to indebtedness arising as a consequence of a sale on credit of any equipment, merchandise or services, except where the sale was between persons not dealing with each other at arm's length; 15 percent for other interest.

20 0 percent for payment in respect of films or tapes (payable to a contracting state or state-owned company); 5 percent for the use of or the right to use any copyright of literary, artistic or scientific work (excluding cinematographic films or tapes for television or broadcasting);15 percent for other royalties.

21 10 percent for interest received by financial situation or in respect of public issues of bonds, debentures or similar obligation; 15 percent for other interest.

22 10 percent for the use of, or the right to use any copyright of literary or artistic work including motion pictures, live broadcasting film, tape or other means of the use of reproduction in connection with radio and television broadcasting or industrial, commercial or scientific equipment; 15 percent for other royalties.

23 8 percent for the right to use industrial, commercial or scientific equipment; 10 percent for other royalties.

24 5 percent for the right to use any copyright of literary, artistic or scientific, including software, and motion pictures and works on films, tapes and other means of reproduction for use in connection with radio or television broadcasting; 10 percent for right to use industrial, commercial or scientific equipment and patent; 15 percent for other royalties.

25 5 percent for the right to use any copyright of literary, artistic or scientific works; 10 percent for other royalties.

26 10 percent for the use of, or the right to use any copyright of literary, artistic or scientific works including software, motion pictures, live broadcasting, film, tape or other means of the use or reproduction in connection with radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial or scientific experience.

27 10 percent if the beneficial owner of the interest is a resident of the other Contracting State.

28 10 percent for the use of, or the right to use any copyright of literary, artistic or scientific works including cinematograph film or films or tapes used for television or radio broadcasting any patent, trademark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial or scientific experience.

29 10 percent of the gross amount of the interest if the interest is beneficially owned by any financial institution or insurance company; 10 percent of the gross amount of the interest if the interest is beneficially owned by a resident of the other Contracting State and is paid with respect to indebtedness arising as a consequence of a sale on credit by a resident of that other Contracting State of any equipment, merchandise or services, except where the sale was between persons not dealing with each other at arm's length; and 15 percent of the gross amount of the interest in all other cases.

30 (a) 5 percent of the gross amount of the royalties if they are made as consideration for the use or the right to use any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting; (b) 8 percent for the use of, or the right to use, any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial, or scientific equipment; and (c) 10 percent of the gross amount of the royalties in all other cases.

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Turkey

Introduction

The Turkish tax environment for mergers and acquisitions (M&A) has been affected by a number of tax developments, raising some uncertain issues that have yet to be resolved. The Turkish government has introduced numerous measures, including tax amnesty programs and investment incentives, which also affect cross-border M&A investors.

This report begins by explaining recent tax and legal developments that could potentially be important when planning a cross-border merger or acquisition. The report then discusses the key issues to consider when developing a tax-efficient transaction structure.

Two types of capital company are typically used in Turkey for cross-border M&A transactions: a joint stock company (*Anonim Sirket* — AS) and a limited liability company (*Limited Sirket* — Ltd). The following discussions relate to these types of companies unless otherwise stated.

Recent developments

Limitation on financing expense deduction

A new law (Law no: 6322) entered into force on 15 June 2012 that amends certain provisions of the corporate tax law.

Among other changes, up to 10 percent of the sum of financing expenses (e.g. interest, commissions, foreign exchange losses and similar costs and expenses) related to the borrowings that exceed the shareholder's equity of the companies not tax-deductible. There are exclusions from this rule that must be analyzed case-by-case.

The law gives the authority to the Council of Ministers to determine a rate (i.e. up to 10 percent) for the restriction of financing expense deduction. The Council of Ministers have not yet used this authority, so the limitation is not yet in force.

Turkey's corporate tax law already has a thin capitalization regime that restricts the deductibility of financing expenses incurred on borrowings from shareholders/related parties that exceed three times of the shareholders' equity as of the opening balance sheet. Previously, no such restriction applied for financing expenses incurred on borrowings from external parties. Under the new law, a certain percentage of financing expenses on external debt that exceeds the shareholders' equity in the companies can be also rejected as non-deductible expense. This measure is intended to discourage use of excessive debt by companies that do not have strong equity.

In view of these developments, investors interested in Turkey should consider the tax implications of financing in more detail when determining investment models.

Tax relief for angel investors

Turkey introduced new provisions in 2012 (through Law No: 6327) regarding tax incentives for individual investors to encourage investments in start-up companies.

Individual investors (referred to as 'angel investors') can benefit from a tax deduction (limited to 1 million Turkish lira (TRY) per year) for a certain percentage of equity contributions made to start-up companies in certain encouraged sectors. Under regulations issued in 2013, investors who want to benefit from this regime can apply to the Ministry of Economy to obtain a license for qualification as 'individual investor'.

Incentive for contributions to venture capital funds

Turkey also introduced new provisions in 2012 (through Law No: 6322) regarding tax incentives for corporate investors regarding their contributions to venture capital funds.

The provisions allow corporate investors to set up reserves from their current-year profits to invest in 'venture capital investment funds' or 'venture capital investment partnerships' established under Turkish Capital Market Board regulations.

The amount reserved for the venture capital fund can be deducted from the corporate tax base for the relevant year, which helps reduce the corporate tax amount.

However, the following conditions should be met in order to benefit from the tax advantage:

— The fund amount should be limited to up to 10 percent of declared profits and up to 20 percent of shareholders' combined equity.

— The fund should be invested until the end of the year in which such fund is reserved.

— The fund should be reserved under a temporary account in the liabilities section of the balance sheet. If the fund is withdrawn, previously accrued taxes must be paid with late payment interest.

Investors should re-invest this fund within 6 months following the disposal date of shares/interests in the venture capital trust or investment fund. Dividends to be received by Turkish companies from a venture capital trust or investment fund are entitled to benefit from a participation exemption for corporate tax purposes under the new law.

These incentives for individual and corporate investors aim to create an alternative channel to meet the financing requirements of start-up companies. It is expected that such companies will be ready for a more structured investment or M&A transaction in the future.

Exemption for the income derived from intellectual property

As of 1 January 2015, a corporate tax exemption applies to 50 percent of the income derived from the leasing, transfer, sale, mass production in Turkey and marketing of inventions of corporate taxpayers that have a patent or utility model registration and result from research, development, innovation and software activities (generally referred to intellectual property — IP) carried out in Turkey, provided that certain conditions are met. If the invention is used in the manufacturing of a product, 50 percent of the income derived from the product's sale can also be tax-exempt (limited to the portion of income attributable to the patented innovation). Certain procedural requirements in the law must be met to benefit from this exemption.

Incentive for cash capital increases (notional interest deduction)

As of 1 July 2015, stock corporations (except for those operating in the finance, banking and insurance sectors) may deduct from taxable income 50 percent of the interest to be calculated over cash capital increase amounts registered in the Trade Registry or over cash capital contributions to newly established corporations. This treatment is similar to the so-called 'notional interest deduction' applied in some other countries. The deductible interest amount is calculated by applying the latest 'annual weighted average interest rate announced by Turkish Central Bank to the TRY-denominated commercial loans granted by banks. The deductible interest is computed for the period from the date of the capital increase to the end of the financial year. In June 2015, the deduction rate (50 percent) was increased for publicly held corporations and for investments in the context of an investment incentive certificate.

Tax law changes expected in 2018

The government announced its intention to make further tax legislation changes in fiscal year (FY) 2018, including amendments to the Turkish Income Tax Law (No: 193), Value Added Tax (VAT) Law (No:3065) and Tax Procedural Law (No: 213).

The draft version of the Income Tax Law proposes certain limitations to the current tax exemptions for individuals on gains from the disposal of shares and real estate property. The draft version of the Tax Procedural Law also includes an enhanced version of the 'substance-over-form' principle, which many tax inspectors rely on to challenge tax structures. The principle is similar to that proposed by the Organisation for Economic Co-operation and Development (OECD) in the context of its Action Plan on Base Erosion and Profit Sharing (BEPS). Developments related to the proposed Turkish tax changes should be monitored throughout 2018 in light of their potential effect on the M&A deals and tax structuring considerations.

Transfer pricing regime and impact on M&A market

Following global trends, the Turkish Revenue Administration relies on indirect taxes and has implemented new compliance rules and tax audits in accordance with the transfer pricing provisions.

Since the implementation of Turkey's transfer pricing regime in 2007, the tax authorities have increased their focus on transfer pricing to protect and widen the domestic tax base. Key developments are as follows:

— In August 2009, the Turkish Revenue Administration issued guidance relating to the Mutual Agreement Procedure in the Treaties for Avoidance of Double Taxation.

— The Turkish Revenue Administration published guidelines regarding disguised profit distribution through transfer pricing in November 2010.

— The Turkish Revenue Administration negotiated and signed the country's first unilateral APA in 2011. KPMG in Turkey expects this will lead to more unilateral APA applications, paving the way for bilateral and multilateral APAs in the future.

— In 2017, The Turkish Revenue Administration issued a Transfer Pricing Communique with guidance and details on the APA process.

— In 2016, new provisions transfer pricing provisions were enacted in tax law no. 6728. The new law adds a threshold of 10 percent to 'related party' definition, removes the hierarchy of transfer pricing methods, enables a 50 percent penalty reduction in the case of timely and proper transfer pricing documentation and allows for the roll-back of APAs.

— As a member of both the G20 and the OECD, Turkey supports BEPS initiatives. In line with BEPS Action 13, the Turkish Revenue Administration published a draft

communique covering master file, country-by-country reporting and local file requirements. A draft Council of Ministers' decision (CMD) was published in 2017 accordingly and was finalized as of 2018.

In view of these developments, cross-border investors considering an M&A investment in Turkey should evaluate the transfer pricing rules applicable to the operations in the past and how they might change after the investment of a foreign company. In particular, if an investor intends to change the operating model (e.g. from an independent sales agent to a limited risk distributor), the likely impact on the financial and tax status of the Turkish company should be analyzed in detail to avoid potential disputes with the Turkish tax authorities.

Turkish Commercial Code: a new legal and financial landscape

The new Turkish Commercial Code (TCC) took effect as of 1 July 2012. As of 1 January 2013, it is mandatory for Turkish companies to prepare their standard financial statements in Turkish Financial Reporting Standards (TFRS; similar to International Financial Reporting Standards — IFRS). There is also a mandatory independent audit requirement under the new TCC, similar to regimes applied in many western economies. Certain exemptions were introduced for small and medium-sized companies.

Needless to say, the new TCC is changing the legal and financial landscape for Turkish companies. The law aims for more transparency of the companies and more accountability for shareholders and directors who manage those companies.

These developments are also likely to bring important benefits to M&A players in the market. Historically, the accounts of Turkish companies (except for listed and/or regulated entities) were usually maintained for tax purposes and were not required to be audited or disclosed in any manner. Under the new rules, there is more reliable and standard financial data about Turkish entities. External audit reports can be expected to increase the level of confidence of a foreign investor in evaluating a Turkish target and reduce the time and effort required for due diligence or partnership negotiations.

The new TCC brings new concepts into Turkish company law that may be of special interest for M&A investors:

— The new TCC covers the legal framework of company reorganizations, such as mergers and demergers (previously covered mostly by tax laws), aiming to smooth the legal implementation of such reorganizations.

— Re-domiciliation of companies will be possible under the new TCC. Re-domiciliation of an existing company is an alternative to liquidation and allows for the transfer of assets and liabilities to an entity incorporated in another jurisdiction. The related guidelines and corresponding amendments in the Turkish tax legislation are not yet available; they are expected to be adopted by Turkish authorities in future during the phase of application of the new TCC.

— The new TCC clearly defines the status and rights of minority shareholders and provides specific rules for 'minority squeeze-outs', which are a major consideration in an M&A of a target company involving minority shareholders.

— With the new TCC, it is now possible for a company to acquire its own shares (limited to 10 percent of the capital).

— The new TTC restricts shareholders from being indebted to their companies (except for advance dividend distributions), which creates a major obstacle to repatriation. This restriction also limits the possibility of leveraged buy-outs in Turkey since it is no longer possible to use the assets of a target company to receive a loan for a potential share acquisition of that company.

OECD Action Plan on Base Erosion and Profit Shifting

As a G20 member, Turkey was one of the first countries to support the OECD's Action Plan on BEPS, which set a framework for developing internationally agreed means to deter harmful tax actions and improve tax transparency.

Turkey is now evaluating and implementing the plan. Among other things, Turkey is working to conclude exchange of information treaties with certain countries and to revise current tax treaties to cover the new exchange of information rules. On July 2015, Turkey signed the automatic information exchange agreement (together with 97 jurisdictions) under the OECD's Standard for Automatic Exchange of Information in Tax Matters. This is particularly important for the Turkish tax base, as material amounts of funds are known to be kept offshore for primarily tax avoidance purposes.

The Turkish government has tried to overcome this problem through some local initiatives, for example, by implementing Asset Peace Acts and Tax Amnesty Acts in previous years. However, a permanent solution has not been obtained, so Turkey has put strong emphasis on the Action Plan on BEPS to encourage Turkish businesses, for example, to stop keeping unrecorded accounts offshore.

In addition, on 7 June 2017, Turkey (together with 67 other jurisdictions) signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI) at a signing ceremony hosted by the OECD in Paris.

On signing, Turkey designated a list of 90 tax treaties as covered tax agreements, which are tax treaties that would be amended through the MLI. Turkey also submitted a provisional list of reservations and notifications for various provisions of the MLI. The formal procedures for the MLI to be effective (i.e. ratification and approval by parliament and the president) are not yet complete.

A significant amount of cross-border M&A and investment in Turkey has been structured through favorable tax jurisdictions or tax treaty countries. The impact of the Action Plan on BEPS on those structures should be analyzed. This review should extend to potential changes adopted by the other countries.

Further, Turkish and foreign investors and Turkish taxpayers who hold foreign properties should analyze the impact of the changes under the Action Plan on BEPS for their current investments and future investment plans.

Asset purchase or share purchase

A foreign company can acquire a Turkish company by acquiring either its assets or its shares.

An asset acquisition can be effected either through a branch of the foreign entity, which is taxable in Turkey as a non-resident, or through a Turkish subsidiary of the foreign company.

Purchase of assets

Goodwill (i.e. a positive difference between the purchase price and the fair market value of assets acquired, if any) can be recognized and depreciated over 5 years.

Tangible and intangible assets can be amortized, based on the rates determined in accordance with the useful life of the assets as announced by the Ministry of Finance.

Transfers between the related parties have to be at fair market value.

Purchase price

In principle, the transfer of assets under an asset transaction should be conducted at fair value, which should be the market value. Transfers between related parties must be documented to comply with transfer pricing requirements.

For the buyer to book the individual assets at their transfer value and determine the goodwill amount (if any), the purchase price must be allocated to individual assets being transferred. It is generally advisable for the purchase agreement to specify the allocation, which is normally acceptable for tax purposes provided it is commercially justifiable.

The allocation of purchase price is more important if there are any assets in the deal that may be exempt from corporate tax and/or VAT on transfer, such as real estate property or shares/ participation rights in another entity.

Goodwill

In the case of an asset deal, an excess of the purchase price over the fair value of the assets being transferred represents goodwill, which can be capitalized by the buyer and depreciated for tax purposes over a period of 5 years.

Turkish tax law does not require recognition of internally developed goodwill and rights in the tax basis balance sheet, so there is usually no tax basis cost for the goodwill in the seller's books and it represents pure taxable income.

Depreciation

The depreciation period of an asset is refreshed in an asset deal. The selling entity may deduct all remaining net book value of assets as the tax basis cost against the transfer value. The buyer must book the assets at their transfer value and start depreciating a new term of useful life for each asset (as prescribed by communiqués of the Ministry of Finance).

Tax attributes

Tax attributes, such as tax losses and incentives, are not transferred to a buyer in an asset deal. The selling entity has the right to use its existing tax losses and VAT credits against the taxable profits (such as capital gains) and VAT obligations arising from the asset transfer.

Where the target has used an Investment Incentive Certificate (common in energy investments), the transfer of assets for the first 5 years is subject to the permission of the Turkish Treasury. The transfer also may cause a denial of potential tax exemptions to which the seller is already entitled under the certificate.

However, the potential tax liabilities of the seller should not transfer to the buyer in the course of an asset deal. An exception is identified in the Law Regarding Collection of Public Receivables. Under this provision, the tax office may put aside the legal nature of a transaction and pursue the assets if the deal is structured to avoid payment of the seller's tax liabilities (which may only be possible in the case of related-party transactions).

Value added tax

Tax-free mergers (including tax-free mergers of small and medium-sized enterprises) and tax-free divisions that meet certain conditions in the corporate tax law are exempt from VAT.

Taxable mergers and asset transactions (including transfers of goodwill) are generally subject to VAT at 18 percent. There is an exemption for real estate property and for shares/ participation rights held by a company for at least 2 years and transferred through an asset deal.

The buyer is entitled to recover the VAT incurred against its output VAT generated from its operations. As a result, the recovery of input VAT may impose a financial burden (time value of money) if the capacity to generate output VAT is limited after the acquisition.

Sales of shares in an AS company are exempt from VAT. A sale of shares in a LTD company by another company is exempt from VAT, provided the participation is held for at least 2 years.

A sale of shares (in either an AS or LTD company) by an individual is not subject to VAT.

Transfer taxes

Certain documents prepared in Turkey (e.g. loan contracts, mortgage instruments) are subject to stamp duty, usually at 0.948 percent. The maximum stamp tax payable on a document is capped at TRY2,135,949.30 for year 2018. Loan contracts (and security documents, e.g. mortgages) for loans from local and foreign banks as well as financial leasing contracts are exempt from the stamp duty.

Merger agreements are also subject to stamp duty. A stamp duty exemption is available for documents related to tax-free mergers and tax-free divisions (that meet conditions in the corporate tax law) and for documents related to the sale of real estate property or shares/participation rights held by a company for at least 2 years.

In an asset deal involving a transfer of title to real estate, the seller and buyer are each subject to a title deed registration fee of 2 percent for 2018.

Purchase of shares

An acquisition of shares by a foreign entity has no immediate Turkish income tax consequences.

If the acquisition is made through a Turkish branch or subsidiary, goodwill implicit in the share price cannot be recognized for tax amortization purposes. Further, it is not possible to achieve a tax basis step-up for the target company assets.

A change in the shareholders does not affect the tax attributes of the target company.

Tax indemnities and warranties

In a share deal transaction, the historical tax liabilities of the target (known or unknown) remain in the company and are acquired by the new shareholder(s). The buyer usually asks for tax indemnities and warranties in a share acquisition.

In Turkey, the accounts of a company are open for tax audit for 5 years. There is no procedure to agree the tax status of a company with the tax authorities. In view of this, and due to insufficient coverage of tax audits in Turkey (i.e. tax authorities can only review a limited number of taxpayers and tax litigation cases usually take a long time to resolve), indemnities and warranties are even more stringently applied in share acquisitions in Turkey.

Tax losses

Tax losses can be carried forward for 5 years. No carry back is possible.

After the acquisition of shares, the target company can continue to carry forward its tax losses without any further requirements.

Tax losses of the merged entity can be used by the merging entity (limited to the amount of the net shareholders' equity of the merged entity) under a tax-free merger if certain other conditions are also satisfied.

Crystallization of tax charges

Since the transfer of shares in a company has no effect on the tax status of the assets, this issue is not applicable for Turkey.

Pre-sale dividend

If the target entity has retained profits available for distribution as dividends, the potential tax implications of a pre-sale dividend versus a capital gain should be considered in light of the circumstances of the buyer and seller.

Transfer taxes

According to a recent change in stamp tax law (Number 6728), enacted on 29 September 2016, documents concluded for share transfers of joint-stock companies, limited liability companies and limited partnerships are exempt from stamp tax.

Tax clearances

It is not possible to ask for tax clearances from the Turkish tax authorities regarding the tax status of a company.

It is only possible to ask for an official statement from the tax office outlining the reported but unpaid tax liabilities of the company or confirming that there are no overdue and unpaid tax obligations. Such statements do not provide assurance against contingent tax liabilities that may be identified in the course of a tax audit.

It is possible to ask for advance tax rulings for specific structural tax uncertainties in a merger or acquisition.

Choice of acquisition vehicle

This section discusses the acquisition vehicles that may be used in structuring a merger or acquisition in Turkey.

In all cases, there is no capital duty or stamp duty on injecting equity into a Turkish company or branch. The equity contribution is subject to a fund (i.e. contribution to the Competition Board) of 0.04 percent (4 per 10,000).

Local holding company

A Turkish holding company usually is structured as an AS or LTD company, or as a specific holding company, which the TCC defines as a special type of an AS formed with the primary purpose of investing in other companies. There is no material difference in the taxation of these forms. However, the special holding company is advantageous because it has a higher dividend capacity than other forms.

Turkish corporate tax law also sets out a special holding company regime entitled to additional tax incentives for the purpose of holding the shares or foreign investments through a holding company in Turkey.

A Turkish holding company is not usually seen as efficient for tax purposes. The absence of a tax grouping regime in Turkey means that acquisition costs and interest expenses at the holding company level cannot be offset against the target's profits. In theory, it is possible to achieve deductibility of acquisition costs and interest expenses through a post-acquisition merger of the holding company into the target. However, such structures are under scrutiny by the Turkish tax authorities and have been challenged through the substance-over-form principle. Such structures should be analyzed carefully, and professional advice should be sought case-by-case.

A Turkish holding company may be a tax-efficient option if the acquisition in Turkey is financed with equity rather than debt and the foreign investor intends to re-invest in Turkey. In this case, the Turkish holding company can receive dividends from the target entity without any tax leakage (i.e. due to participation exemption rules) and use such dividends for re-investment in other Turkish businesses.

Foreign parent company

The foreign buyer may choose to make the acquisition itself, perhaps to shelter its own taxable profits with the financing costs, without causing any direct taxation problems in Turkey. However, because Turkey charges withholding tax (WHT) on interest and dividend payments to a foreign party, an intermediate company resident in a more favorable treaty territory may be preferable.

Non-resident intermediate holding company

To ensure a more tax-efficient flow of payments from the Turkish entity to its foreign parent and eliminate potential capital gains tax on a subsequent exit, an intermediate holding company resident in another territory could be used. When determining the applicability of treaty benefits, Turkish tax authorities usually rely on a tax residency certificate issued by the tax authorities of the territory in which the intermediary holding is located. As a result, any substance tests should be considered from the perspective of the tax laws of the territory in which the intermediary holding is to be located.

Local branch

A foreign company may hold the shares of a Turkish target through a branch established in Turkey. Although the branch is regarded as a non-resident for tax purposes, it is subject to tax rules similar to those applying to other company forms in terms of its Turkish income and transactions.

In practice, a branch is not seen as a favorable option for several reasons:

— Dividends paid from a Turkish target to the branch are not entitled to participation exemption.

— The remittance of profits and dividends from the branch to its foreign parent is subject to WHT.

— It is an inflexible structure because the branch cannot be legally transferred to a third party later on exit.

Joint venture

A joint venture can be established between a Turkish company and one or more local or foreign entities. If such a joint venture company is incorporated, it takes an ordinary legal form of either an AS or LTD and is subject to the same tax implications. An incorporated joint venture may be registered for tax purposes, but it can only be used for specific contractual works and is not available as a holding company structure.

Choice of acquisition funding

A buyer structuring an acquisition in Turkey needs to consider whether to fund the vehicle with debt or equity. Hybrid financing instruments are not recognized for tax purposes in Turkey, so it is usually necessary to follow the legal definition when classifying a financing structure as debt or equity and assessing the tax implications.

The principles underlying these approaches are discussed below.

Debt

There is no limit on the amount of debt that can be put into a Turkish company and no general restriction on the deductibility of interest. Interest expenses incurred for business purposes are deductible on an accrual basis.

Interest expenses incurred for financing an asset acquisition need to be capitalized as the depreciated cost of the asset until the end of the year in which the asset is acquired. Interest expenses incurred thereafter can either be recognized as period expenses or capitalized.

The deductibility of interest may be restricted by thin capitalization or transfer pricing rules (discussed later in this report).

Debt financing from a foreign source may attract a surcharge (0 to 3 percent) if it is in the form of a foreign loan and based on the average maturity of the loan. This can be avoided by structuring the loan in a foreign currency and with an average maturity of 3 years or more.

Debt financing from a local source in Turkey (e.g. a bank) does not attract the surcharge. However, the interest payments are subject to a banking transaction tax, generally at 5 percent.

Deductibility of interest

As noted earlier, Turkish tax laws do not impose a general restriction on deductibility of interest. Some specific restrictions are explained below.

Thin capitalization rules

Where the amount of debt (measured at any time during the year) provided to a Turkish entity by its shareholders (or related parties) exceeds three times the equity (i.e. shareholders' equity measured as per the statutory accounts opening balance sheet of the period concerned), the excess of debt above the 3:1 ratio is re-characterized as disguised equity. As a consequence:

— Financing expenses incurred on the disguised equity (related-party debt exceeding three times shareholders' equity) cannot be deducted for corporate tax purposes.

— Interest actually paid on the disguised equity is re-characterized as disguised dividends and subject to dividend WHT at 15 percent (unless reduced by treaty).

Injecting equity or reserves into the company within a period does not help to overcome the thin capitalization status for the current period, because the shareholders' equity is measured as at the opening balance sheet, but it may help for subsequent periods.

When debt is obtained from an external bank against cash guarantees provided by the shareholders, the thin capitalization rules still apply.

Transfer pricing rules

When a Turkish entity receives funding from its shareholders (or related parties), the interest and other expenses charged on the loan should be at arm's length. Any excess interest/expense paid by the Turkish entity above an arm's length rate cannot be deducted for corporate tax purposes. The excess amount is re-characterized as disguised dividends and subject to dividend WHT at 15 percent (unless reduced by treaty).

Turkey's transfer pricing regulations are similar to the OECD guidelines; normally any report or documentation prepared in a foreign country employing the same rules should be suitable as supporting documents in Turkey.

Interest incurred on share acquisition

Generally, expenses incurred for the purpose of tax-exempt activities are not deductible against income from other taxable activities of a company. Previously, this general rule posed problems for a holding company with interest expenses incurred for the purpose of acquiring shares in another Turkish entity, which potentially led to tax-exempt dividend and capital gains income.

The corporate tax law stipulates that a holding company in a similar position has the right to deduct such interest expenses against taxable income derived from other activities. In practice, however, a pure holding company does not generate taxable income. Thus, interest expenses carried forward as tax losses may not be utilized and expire after the carry forward period of 5 years. In such cases, further post-acquisition structuring may be required.

Withholding tax on debt and methods to reduce or eliminate it

Interest payments to non-resident corporations are subject to WHT at varying rates of 0, 1, 5 percent and 10 percent. The WHT rate is reduced to 0 percent where the interest is paid to a lender who qualifies as a foreign bank or financial institution.

Interest payments to foreign parties other than banks may attract 18 percent VAT on a reverse-charge basis if the foreign party receiving the interest does not qualify as a bank or financial institution. Such VAT is normally recoverable by the Turkish borrower unless the underlying interest is not tax-deductible.

A stamp tax of 0.948 percent applies on the loan contract unless the loan is received from a bank or financial institution.

Therefore, it is usually less efficient for the Turkish entity to borrow directly from its foreign parent/group entity. These tax inefficiencies may be improved through some additional structures.

The corporate tax law contains certain anti-avoidance rules for transactions with entities in low-tax jurisdictions (tax havens). A 30 percent WHT applies to various types of payments to residents of those jurisdictions, which will be named on a list to be published in the future by the Ministry of Finance. The impact of these rules on the ultimate WHT application should be considered.

Checklist for debt funding

— The use of external bank debt may avoid thin capitalization and transfer pricing problems, but debt obtained from an external bank against cash guarantee provided by the shareholders is still subject to thin capitalization rules.

— The use of external bank debt (even with a guarantee by shareholders) should eliminate the WHT and VAT implications on interest payments unless the structure is open to challenge on substance grounds.

— In addition to thin capitalization rules that apply to borrowings from related parties, up to 10 percent of the financing expenses incurred on all borrowings that exceed the shareholders' equity of the company can be classified as non-deductible expense (this rule will enter into force when the Council of Ministers issues a decree to determine the rate of restriction, up to 10 percent).

— The absence of tax grouping means interest expenses incurred by a holding company in Turkey cannot be offset against taxable profits of the target. Such an expense can be carried forward as a tax loss to be offset against any other taxable gains that may arise in future.

— Contributions to the equity and reserves of the Turkish entity in 1 year are included in the debt-to-equity calculation for the following year. When considering the

required related-party debt capacity of the following year, any required injection to equity or reserves by the shareholders should be completed before the current period ends.

— Tax deductions may be available at higher rates in other territories.

— A debt from a foreign source may attract a surcharge (0 to 3 percent), if it is in the form of a foreign loan and based on the average maturity of the loan. This surcharge can be avoided by structuring the loan in a foreign currency and with an average maturity of 3 or more years.

— A debt from a local source (e.g. a bank) in Turkey does not attract this surcharge. Interest payments may be subject to a banking transaction tax, generally at 5 percent.

Equity

Equity injections are subject to a Competition Board fee of 0.04 percent, with no limit and including additional capital injections to the corporation. The fee is also payable on capital in kind contributions. No other taxes or duties are levied on equity funding.

The level of equity funding in a Turkish entity may need to be considered for other reasons, such as:

— More equity may lead to an increased legal reserve requirement in the entity (as a percentage of the equity), and so reduce the dividend capacity.

— Equity is less flexible should the parent subsequently wish to recover the funds because the reduction of equity in a Turkish company is subject to a regulated process that requires, among other things, the approval of a trade court.

— In view of Turkey's thin capitalization rules (3:1 debt-to-equity ratio), a tax-efficient related-party financing structure may require a review of the equity level in the entity.

— There may be other non-tax grounds for preferring equity. For example, in certain circumstances, it may be desirable for a company to have a pre-determined debt-to-equity ratio. This may apply to companies that are subject to industrial regulations (e.g. Turkish holding company of a bank or insurance company) or that expect to submit public bids (e.g. privatization projects or license applications).

Tax-free reorganizations

Turkish corporate tax law allows for tax-free mergers, divisions and share swaps, provided that certain procedural obligations are met. Such tax-neutral reorganizations are performed on the basis of book values (i.e. no step-up for the value of the assets), and the historical tax liabilities, if any, are assumed by the surviving entities.

Hybrids

Hybrid financing instruments are not recognized for tax purposes in Turkey. It is usually necessary to follow legal definitions to classify a financing structure as debt or equity and determine the tax implications.

The thin capitalization rules also need to be considered where the lender is a related party.

Discounted securities

The tax treatment of securities issued at a discount differs from the accounting treatment in the sense that the issuer cannot immediately deduct the difference between nominal and discounted values. In Turkey, the main borrower is the government. Few private debt securities are issued by the private sector so the tax treatments on special cases are not tested in practice.

Deferred settlement

An acquisition often involves an element of deferred consideration, the amount of which can only be determined at a later date on the basis of the business's post-acquisition performance. The right to receive an unknown future amount is not regarded as an asset that must be valued for Turkish tax purposes. Such amounts should represent a part of the transaction (as a tax-triggering event) at the date when the due amounts can be calculated and claimed by the parties according to the terms and conditions of the contract.

For example, in a normal share acquisition structure, the deferred settlement amounts should be included in the final purchase price as a price adjustment and may be taxed or exempted, depending on the tax status of the original transaction. The tax treatment of such transactions also depends, to certain extent, on the legal definition and interpretation derived from the relevant agreements.

Other considerations

Turkey normally does not tax the gains of non-residents except where the non-resident has a permanent establishment or a permanent representative in Turkey and the income can be attributed. A specific tax regime applies to capital gains derived from disposal of shares by a non-resident. The gain on a sale of shares/participation rights of a company in Turkey may become taxable in Turkey where:

— the transaction occurs in Turkey

— the transaction is evaluated in Turkey (i.e. paid by or born as expense by a Turkish taxpayer).

Such transactions have to be evaluated for Turkish tax purposes, depending on the status of the buyer and the seller, the type of the entity whose shares are being transferred, and the method used to effect the share transfer.

Concerns of the seller

The seller is liable to tax on gains realized on the sale of the assets of a business. Losses arising from the sale of assets can be immediately deducted or carried forward.

The seller is liable to tax on gains arising from the sale of shares. Losses are available to offset income from other activities of the corporation.

Fifty percent of gains derived from the sale of real estate property and 75 percent of gains derived from the sale of shares of a Turkish company by another Turkish company may be exempt from corporate taxation, provided the property was held for at least 2 years and the exempt gains are retained in a special reserve account for 5 years. This requirement not to repatriate funds for 5 years may be impossible to satisfy, of course, if the seller plans to leave the business entirely.

Since gains derived by a Turkish individual from the sale of shares of a Turkish AS after 2 years are tax-exempt, the seller would strongly oppose structuring the transaction as an asset deal or expect the buyer to bear the resulting tax by way of a corresponding increase in purchase price.

Moreover, apart from taxation reasons, a seller in need of cash would be reluctant to agree to an asset deal because the repatriation of cash from the selling entity to its shareholders would also pose problems.

Company law and accounting

A foreign company may do business in Turkey by operating as a contractor, establishing a branch, or forming a subsidiary. All became subject to the TCC as of 1 July 2012.

The uniform chart of accounts (as defined by the Turkish Tax Procedural Code) is compulsory for all companies except those subject to regulatory and/or supervisory agencies, which should use TFRS for their sectors, including banks, brokers, and insurance, leasing and factoring companies. TFRS is aligned with IFRS. The annual accounts for all companies must include an income statement, balance sheet and notes to each. Accounts must be drafted and approved at the general shareholders meeting within 3 months of the end of the financial period.

With the implementation of the TCC, all companies have continued keeping their legal books in accordance with Turkish Tax Procedural Code and applying the uniform chart of accounts. Companies that meet criteria set out in the law also are required to present their financial statements in line with TFRS (which is identical to IFRS), as of 1 January 2013. TFRS is mandatory for companies that issue financial statements subject an external audit requirement.

Group relief/consolidation

Consolidation for tax purposes is not allowed. Each entity is subject to tax on a standalone basis.

Transfer pricing

Turkey's transfer pricing regulations, in effect since 2007, generally align with the OECD model. The regulations are applicable to domestic and cross-border transactions between related parties. However, a transfer pricing adjustment is not required for domestic transactions between Turkish tax-registered entities as long as there is no ultimate fiscal loss for the government.

The regulations require prices, fees and charges for intercompany transactions (including interest on intragroup financing) to be determined on an arm's length basis, as determined by an acceptable methodology.

Dual residency

Dual residency status is not mentioned in Turkish tax laws, so it is not relevant from a Turkish tax perspective when structuring an M&A transaction in Turkey.

Foreign investments of a local target company

Turkey has introduced a controlled foreign company (CFC) regime in the new corporate tax law. CFC status is determined by a number of criteria. Normally, an operating company with an active business should not be classified as a CFC. By contrast, an intermediary holding company owned by a Turkish company would likely be deemed as a CFC where the intermediary holding company benefits from a participation exemption regime and effectively pays no taxes in its territory. The acquisition of shares in a Turkish target should not lead to a change in the CFC status of its foreign investments.

Turkey also introduced a holding regime in the new corporate tax law to encourage holding foreign investments through a company established in Turkey. The form of the company can be the usual AS or Ltd.

There are no particular requirements from a company law perspective to qualify as a holding company.

If the holding company meets the conditions stipulated in the corporate tax law, the dividends and potential capital gains on investments of the Turkish target can be fully exempt from corporate taxes. Further, the dividend WHT to be applied during the ultimate repatriation of profit from the Turkish target to its shareholders is reduced to 7.5 percent (instead of 15 percent).

Comparison of asset and share purchases

Advantages of asset purchases

— Purchase price can be depreciated or amortized for tax purposes.

— Step-up in tax basis (through revaluation) is obtained.

— Previous liabilities of the seller are not inherited.

— Possible to acquire part of the business.

— More flexibility in funding.

— Possible to absorb a profitable business into a loss-making company.

Disadvantages of asset purchases

— Potential need to renegotiate existing agreements and renew licenses, among others.

— More transaction costs (e.g. stamp taxes, title deed registration fees).

— Exemptions on sale of shares are not applicable.

— Tax losses remain with the seller.

— Not favorable for the seller in terms of cash flow.

Advantages of share purchases

— Purchase on net asset basis, so lower capital outlay.

— Likely more attractive to the seller due to available tax exemptions and cash flow.

— Buyer acquires tax attributes of the target, including tax losses.

— Buyer continues to enjoy existing contracts and licenses, among others.

Disadvantages of share purchases

— Acquisition of potential tax liability (difference between market value and tax basis of assets in the target company, which would be crystallized in future on disposal of such assets).

— Inability to recognize goodwill for tax depreciation.

— Acquisition of contingent (unknown) tax liabilities of the target.

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United Arab Emirates

Introduction

The United Arab Emirates (UAE) is a federation of seven emirates: Abu Dhabi, Dubai, Sharjah, Fujairah, Ras Al Khaimah, Ajman and Umm Al Quwain.

All companies are required to obtain a license in order to undertake business activities in the UAE. The type of licenses that are generally available include a trading license, an industrial license and a service license.

Legislative framework for M&As

Federal Companies Law

UAE Federal Law No.2 of 2015 Concerning Commercial Companies (CCL) is relevant when considering mergers and acquisitions (M&A) in the UAE.

The scope of the CCL covers all commercial operations established in the UAE except:

— companies excluded by resolution of the UAE Federal Cabinet

— companies wholly owned by federal or local governments, if a special provision is provided in the company's memorandum

— companies operating in certain oil, gas and power sectors in which the federal or local government directly or indirectly holds 25 percent.

The CCL also extends to Free Trade Zones (FTZs) operating in the Mainland UAE.

A merger under the CCL can be effected either by one company absorbing another company or by a combination of two or more companies being absorbed by a new company. The CCL allows companies to merge by a contract specifying the method of conversion of the existing entity's (or entities') shares. The CCL also introduces a short-form merger procedure between a holding company and a fully owned subsidiary, as well as between two or more fully owned subsidiaries of the same holding company where no merger contract is required.

An acquisition can also take place by buying shares in a company, subject to foreign investment regulations.

Foreign investment

There are two types of investment locations in the UAE, namely, Mainland UAE and the various FTZs. The key distinction between these two investment locations is based on the foreign ownership restrictions.

Mainland UAE

Mainland UAE is the wider UAE, where foreign investment restrictions apply. In particular, a foreign shareholder cannot own more than 49 per cent of the shares in a company. The remaining 51 per cent must be owned by a UAE national individual or UAE national company.

The benefit of registering a Mainland UAE entity is that there are no restrictions on undertaking business activities inside or outside the UAE, provided that the licensing requirements are met. A Mainland UAE-registered entity can enter into contracts directly with Mainland customers and public entities, which is not permissible for an entity registered in the FTZ.

The CCL allows the UAE Council of Ministers to identify sectors and companies that may be either majority owned or wholly owned by foreign shareholders. The amendment was issued by Decree pursuant to Law No. 18 of 2017 and came into force on 28 October 2017. At the time of writing, it is unknown which economic sectors or entities will have the relaxed ownership requirement.

A foreign company can set up a representative office or a branch in the UAE, but a national/local service agent is required.

Free Trade Zones

There are around 45 FTZs in the UAE. FTZs are designed to promote foreign direct investment in the country. The benefits of setting up in a FTZ include 100 per cent foreign ownership, a guaranteed tax holiday and pre-built business space, along with a customs duty exemption for imports into the FTZ.

FTZ entities are only licensed to do business either within the FTZ in which they have been established or outside the UAE altogether (subject to the laws of the countries concerned).

Each type of FTZ entity is allowed to be 100 per cent foreign owned, with no requirement to appoint a local agent or sponsor.

Tax decrees

There is no corporate tax legislation at the Federal UAE level. Some of the seven emirates (including Dubai) have introduced corporate taxes through their own decrees. Currently, these taxes only apply to foreign oil companies and branches of foreign banks.

Foreign oil companies separately enter into concession agreements with the Ruler of the Emirate in which they extract and/or produce oil. The tax paid by an oil company can range from 55 to 87 percent.

For branches of foreign banks, corporate tax is generally calculated at the rate of 20 per cent of taxable income. The tax decrees do not mention the consequences of company M&As or disposals.

The UAE did sometime announce its intention to introduce the federal (unified) corporate tax regime applicable for all Emirates and all industries. However, any details on the proposed regime and its implementation date are not known yet.

UAE is also actively considering implementation of the minimum standards under the Organisation for Economic Co-operation and Development's (OECD) Action Plan on Base Erosion and Profit Shifting. The implications of any BEPS measures adopted by the UAE would need to be analyzed once the Ministry of Finance has made a formal announcement.

Withholding tax and capital gains tax

Currently, the UAE does not impose withholding tax or capital gains tax.

Value added tax

As of January 2018, the UAE has introduced a VAT with a standard rate of 5 percent. The national legislation is based on a framework agreement established by six Gulf Cooperation Council (GCC) countries. The VAT Decree Law was published in August 2017 and supplemented by Executive Regulations published at the end of November 2017. Given that VAT is the first federal tax within the UAE, Federal Tax Authority established in the second quarter of 2017 to administer the VAT and any future taxes.

Given the short implementation timelines and the newly established authority, a lot of legislative questions are still outstanding and no practice of rulings or litigation has been established.

The general principles of UAE VAT are similar to those of European countries:

— Businesses are required to register for VAT if they are involved in taxable activities with turnover of more than 375,000 UAE dirhams (AED; about 100,000 US dollars — US$).

— Businesses are required to charge VAT on supplies of goods or services within the territory of the UAE.

— Businesses can recover VAT incurred with respect to making taxable supplies.

The important document for businesses for VAT compliance is a tax invoice. Businesses are required to issue tax invoices for all of their taxable supplies, and VAT can only be recovered when the business possesses a correct, compliant tax invoice.

Asset purchase or share purchase

Purchase of assets

There are no specific provisions relating to asset purchases or M&As in any of the tax decrees. Where a merger or acquisition involves an entity or entities that are currently subject to corporate tax in the UAE, the tax implications, including purchase price allocation, treatment of goodwill and continuity of tax attributes, should be considered case-by-case.

Value added tax

In the context of M&A transactions, the VAT Degree Law provides for an exception whereby the transfer of whole or independent part of business to a taxable person for purposes of continuing the business would not be considered a supply. It is anticipated that this concept would apply to a transfer of a particular part of the business but not to transfers of single business assets.

Transfer taxes

There is no stamp duty on the acquisition of assets, except on the acquisition of real property, where a registration fee may be due, depending on the Emirate in which the property is situated.

Purchase of shares

As mentioned previously, an acquisition can be achieved by buying shares in a company, subject to foreign investment restrictions.

Value added tax

As is typical with most VAT regimes, many financial services are treated as exempt. The UAE has taken a very narrow approach to exemption, limiting it to financial transactions where consideration is by way of a margin, with all fee-and commission-based services being taxed at the standard rate. Where a business is transferred through a sale of shares, the financial services exemption needs to be considered. The Executive Regulations set out the treatment and definitions of financial services. The regulations exempt any transfer of ownership in an equity security from VAT.

Transfer taxes

There is no stamp duty on the acquisition of shares.

Choice of acquisition vehicle

As mentioned above there are two investment locations in the UAE — Mainland UAE and the various FTZs. The following entity types are generally available:

Mainland UAE

In Mainland UAE, a limited liability company (LLC) or joint stock company may be incorporated, subject to foreign investment restrictions that restrict foreign ownership to only 49 per cent of the share capital of the entity.

Under the recent changes to the CCL, the UAE Council of Ministers may identify sectors and companies that may be either majority owned or wholly owned by foreign shareholders.

A representative office or a branch of a foreign company may be established (a national/local service agent is required).

Free Trade Zones

In an FTZ, an entity could be incorporated with 100 percent foreign ownership. No local sponsorship for branches is required.

In FTZ, a free zone establishment company (one shareholder) or free zone company/free zone LLC (more than one shareholder) may be incorporated.

The above entities must obtain appropriate licenses on registration (renewable periodically) from the relevant authorities.

Local holding company

A local holding company can be established either in the Mainland UAE (foreign ownership restrictions should be considered) or in the FTZs (a limited number of FTZs allow purely investment activity).

Choice of acquisition funding

The UAE has no specific thin capitalization rules or no exchange control regulations. Funds can be easily repatriated. Under the CCL, certain companies (joint stock companies, commercial banks and branches of foreign banks) must allocate at least 10 per cent of their net profits every year to a legal reserve. These allocations can stop once the reserve reaches 50 percent of the company's issued share capital.

Other considerations

Accounting and auditor requirements

The CCL requires locally registered companies to appoint auditors to audit their annual financial statements.

Registered companies in some FTZs are also required to have their financial statements audited annually. The audited financial statements need to be submitted to the respective FTZ authority for license renewal.

Group relief/consolidation

The tax decrees contain no provisions for group relief or consolidation of tax returns.

Value added tax

Group consolidation for VAT purposes is possible where certain requirements are met.

Transfer pricing

Currently, the UAE has no provisions for transfer pricing.

Thin capitalization

Currently, the UAE has no thin capitalization requirements.

Dual residency

There are no provisions in the tax decrees relating to dual residency in the UAE.

Employment of nationals

The UAE has an active 'emiratization' program for the employment of UAE nationals and has identified suitable industries in which they may work. Banking and insurance were identified as two industries in which emiratization is a key requirement. Companies operating in those sectors are required to meet annual quotas. Emiratization rules do not apply to FTZ entities.

The National Human Resource Development and Employment Authority is an agency of the UAE government established to help implement the emiratization program.

Tax treaties

The UAE has tax treaties with the following countries and jurisdictions: Albania, Algeria, Andorra, Armenia, Austria, Azerbaijan, Bangladesh, Barbados, Belarus, Belgium, Bulgaria, Bosnia and Herzegovina, Brunei, Bulgaria, Canada, China, Czech Republic, Cyprus, Egypt, Estonia, Fiji, Finland, France, Germany, Georgia, Greece, Guinea, Hungary, Hong Kong (SAR), India, Indonesia, Ireland, Italy, Japan, Jersey, Jordan, Kazakhstan, Kenya, Korea (Rep.), Kyrgyzstan, Latvia, Lebanon, Liechtenstein, Lithuania, Luxembourg, Macedonia, Malaysia, Malta, Mauritius, Mexico, Mongolia, Montenegro, Morocco, Mozambique, Nation of Brunei, New Zealand, Netherlands, Panama, Pakistan, Philippines, Poland, Portugal, Romania, Russia, Singapore, Serbia, Seychelles, Slovenia, Slovakia, Spain, Sri Lanka, Sudan, South Africa, Switzerland, Syria, Thailand, Tajikistan, Tunisia, Turkey, Turkmenistan, United Kingdom, Ukraine, Uruguay, Uzbekistan, Venezuela, Vietnam and Yemen.

Treaties with many other countries and jurisdictions are currently under ratification. These countries include: Angola, Bermuda, Burundi, Cameroon, Colombia, Costa Rica, Croatia,

Ecuador, Ethiopia, Iraq, Maldives, Mali, Moldova, Nigeria, Palestine, Paraguay, Rwanda, St. Kitts and Nevis, Senegal and Uganda.

Comparison of asset and share purchases

From a corporate tax perspective, there is no difference between asset and shares purchases because there is no corporate income tax except for companies in the oil and gas and banking industries.

For VAT purposes, the transfer of a whole or independent part of business to a taxable person for purposes of continuing the business is not considered as a taxable supply.

This concept is expected to apply to a transfer of particular part of the business but not to a transfer of single business assets.

Where the transfer of business is realized through a sale of shares, the financial services exemption should be considered. The Executive Regulations exempt transfers of ownership in equity securities from VAT.

KPMG in the United Arab Emirates

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Vietnam

Introduction

The Vietnam tax environment for mergers and acquisitions (M&A) continues to evolve. Although gaps remain, new rules may allow for new planning opportunities. The continued development of the rules shows a trend towards converging with international norms. This report provides basic information to potential investors considering deals involving both asset and share purchases.

This report proceeds by addressing three fundamental decisions that face a prospective buyer:

— What should be acquired: the target's assets or its shares?

— What should be the acquisition vehicle?

— What issues should be considered in financing the acquisition vehicle?

Although improving, the tax laws and regulations in Vietnam are changing rapidly and the interpretations often aggressively favor of the Vietnamese tax authorities. Investors into Vietnam should not expect the same degree of legal certainty that is available in more developed jurisdictions.

In addition, investment and enterprise regulations and licensing procedures also play a significant role in the acquisition process in Vietnam and should be reviewed carefully.

Recent developments

Market overview

2016 and 2017 saw exciting growth of M&A activity in Vietnam with the emergence of billion-dollar deals that have had significant influence on numerous industries, including the real estate, chemical, retail and consumer goods, technology and education sectors.

M&A activity in Vietnam has been increasing due to strong foreign interest from the global M&A market, recovery of the real estate market and, in particular, the plan of state ownership divestment and the relaxation of regulations to allow foreign ownership. As a result, Vietnam is once again perceived as a promising growth market.

Legislation and policy changes in 2016 and 2017

— From 1 January 2016, the standard corporate income tax (CIT) rate is reduced to 20 percent (from 22 percent).

— Some recent changes in the Vietnamese tax system have focused on easing the administrative burden for corporations (e.g. quarterly corporate tax filing and the submission of excessive appendices with value added tax (VAT) returns have been abolished).

— Vietnam's transfer pricing environment continues to develop with an increase in tax audit activity in this sector.

— On 7 July 2015, Vietnam and the United States (US) signed their first income tax treaty and simultaneously adopted a protocol for the avoidance of double taxation and the prevention of fiscal evasion of taxes on income. While the treaty and protocol are still to be ratified by each jurisdiction, it will likely offer incentives for direct investment from the US.

Asset purchase or share purchase

An acquisition of a company in Vietnam can take the form of a purchase of assets or the purchase of shares (technically, ownership interests in the case of a limited liability company — LLC). The choice of method of acquisition may be affected by factors such as the potential corporate tax rate on gains, VAT, transfer taxes and other tax attributes.

Many acquisitions in Vietnam occur in the form of a share purchase, which is driven by non-tax and licensing issues. However, asset deals may be more desirable in some cases due to potential liability issues and the ability to rebase the asset value for tax depreciation purposes.

Foreign investors must establish (or already have) a Vietnamese entity to hold assets in Vietnam for investment purposes.

The establishment of a Vietnamese entity or amendment to the business license for an asset purchase can be a lengthy process and may entail multiple approvals. In most cases, the buyer is likely to purchase the shares in the target Vietnamese entity.

Some of the tax considerations relevant to the acquisition of shares and assets are discussed later in this chapter.

The advantages and disadvantages of each method are summarized at the end of this chapter.

Purchase of assets

The main benefit of the purchase of assets is the avoidance of secondary tax liabilities from a share acquisition with less due diligence required. This option is more advantageous for targets with significant potential tax and non-tax exposure that could arise through:

— a long history

— various changes in investors

— changes in the scope of business activities

— a high-profile target and/or owner with heightened reputational risk

— the target keeping two sets of accounting books.

The acquisition of assets must be substantiated by legitimate tax invoices and other supporting documents (e.g. sales invoices, sales contracts).

Purchase price

In Vietnam, the valuation of assets for transaction purposes is a matter of mutual agreement between the seller and the buyer. However, using commercially justifiable valuations is important. The authorities may look to market value (based on their data sources) and have the power to deem values and thereby taxes payable on gains from transactions if they are not satisfied that the transaction reflects commercial reality or the arm's length principle. A simple explanation may not be enough to justify the chosen purchase price. Instead, the local tax authorities (e.g. valuation reports) are more likely to accept documents issued by independent third parties.

The sale of assets is subject to VAT in most cases (at a default rate of 10 percent). The seller of the asset is subject to CIT at 20 percent (22 percent before 1 January 2016) on the gain from the asset transfer.

Goodwill

Acquired goodwill may be amortized over a maximum period of 3 years. In a group context, goodwill is amortized in the entity and any loss arising is not available to offset against profits of other group companies (see 'Tax losses' below).

Depreciation

The CIT rules allow the cost of assets to be written off against taxable profits by means of tax depreciation where certain conditions are met. Depreciation of both new and used fixed assets is calculated based on the historical cost and useful life of the fixed assets within the regulated time frame.

Under Vietnamese rules, an asset is considered to be a fixed asset for tax depreciation purposes where all the following conditions are met:

— There is a high degree of certainty that a future profit will be obtained from utilizing the assets.

— The useful life of such asset is at least 1 year.

— The value of such asset is at least 30,000,000 Vietnamese dong (VND) (approximately 1,400 US dollars — US$).

An enterprise should itself determine the useful life of its fixed assets within the regulated timeframe. Regulations specify maximum permissible effective lives for various classes of assets, including intangibles. Depreciation exceeding the rates specified in the regulations is not deductible. Current straight-line tax depreciation rates are as follows:

Assets	Rate (percent)
Buildings	2 to 16.67
Office equipment	10 to 20
Automobiles	3.33 to 16.66
Machinery and equipment	5 to 33.33
Intangible assets	Not more than 5
Goodwill	33.33

Source: KPMG in Vietnam

Tax attributes

Tax losses and incentives cannot be transferred as part of an asset acquisition. These tax attributes remain with the company (vendor) or are extinguished. There are no specific rules for the acquisition of an entire business (and not in the form of share deal) for CIT purposes in Vietnam.

Where share acquisitions of companies are made, tax attributes can be preserved but conditions and limitations apply.

Value added tax

The transfer of most assets in Vietnam is subject to VAT.

Current law imposes VAT on goods and services at three rates: 0 percent, 5 percent, and 10 percent. The standard VAT rate is 10 percent.

There are no specific rules in Vietnam related to the transfer of a going concern and consequent favorable VAT treatment.

The seller is required to issue VAT invoices for the sale of the asset, and VAT must be added to the sales price and indicated in the invoice issued. The VAT becomes input VAT of the buyer provided the assets acquired are used in business activities that are subject to VAT.

Business establishments are not required to declare and pay VAT on the following transactions:

— capital asset contribution for establishing an enterprise

— transfer of assets between dependent cost accounting entities

— transfer of assets on demerger, division, consolidation or conversion of form of the enterprise.

VAT applies separately from other taxes imposing on the transfer (i.e. on top of CIT and other taxes). In some instances, both taxes apply.

Asset registration tax (stamp duty)

Properties are the most notable assets subject to asset registration tax. Unlike many jurisdictions, the amount of asset registration taxes in Vietnam is capped, making it less material in most cases. When assets subject to the asset registration tax are transferred, the new registered asset owner is required to pay the tax.

Specific asset registration tax rates apply to certain kinds of assets listed in the regulations. For properties, the rate is 0.5 percent. However, as noted above, the materiality of this tax is often limited as the amount of such asset registration taxes payable on any asset cannot exceed VND500 million (approximately US$24,000), except for cars with fewer than 10 seats, aircraft and cruisers which have no cap. Asset registration taxes must be declared when incurred and paid by 30 days after the date on which the tax authorities sign the registration tax notice.

Asset registration taxes are not applicable to share transfers.

Purchase of shares

The purchase of a target company's shares may be preferred in some cases to preserve tax incentives or losses of the target company but is more likely to be driven by licensing matters. In most cases, foreign investors are permitted to hold a maximum stake of 49 percent in a public joint stock company. In most other cases, foreign ownership is not restricted unless specifically provided for under Vietnam's World Trade Organization (WTO) commitments for certain industries and sectors. Since 2009, this liberalization has created a more open investment environment for investors, especially combined with the gradual removal of restrictions on the capital holding ratio of foreign investors in specific sectors, also in line with WTO commitments.

Capital gain tax

Capital gains from the sale of shares are normally subject to the standard CIT rate of 20 percent as of 1 January 2016 (previously 22 percent). The taxable gain is determined as the difference between the sales proceeds less investment cost and transfer expenses. The Vietnamese assignee is required to withhold the tax due from the payment to the assignor and account for this to the tax authorities. However, in case both assignor and assignee are offshore entities, the local target company takes this responsibility by law.

Gains earned by a foreign investor from selling securities (i.e. bonds, shares of public joint-stock companies, irrespective of whether they are listed or non-listed) are subject to CIT at a deemed rate of 0.1 percent of the gross sales proceeds (replacing the capital gains tax applicable on net gains).

Tax treaties may provide some protection from the above taxes. Use of an offshore holding company may provide opportunities for tax mitigation on exit. However, anti-avoidance rules may also apply, with broad interpretation from local tax authorities. Further, tax treaty claims are not reviewed or approved by the local tax authorities until a tax audit is undertaken, which can happen years later.

Tax indemnities and warranties

The tax exposures of a target company transfer to the buyer after a share purchase transaction is completed. Therefore, the buyer should pay close attention to the target company's tax compliance status. For this reason, tax due diligence exercises are important for identifying significant tax issues in M&A transactions.

As the target company's contingent liabilities transfer to the buyer, the tax indemnities and warranties for contingent tax liabilities should be thoroughly addressed in the transaction agreements.

Tax losses

Tax losses of a company can be carried forward fully and consecutively for up to 5 years, starting from the year in which the losses were incurred. Accordingly, losses incurred by the target company prior to the transaction may continue to be offset against the taxable income of the company after the transaction. There are no specific shareholder continuity tests in Vietnam.

There is currently no group relief for losses in Vietnam.

Comparison of asset and share purchases

Share purchases lead to ownership of part or all of the target company, which can preserve licensing benefits of that target entity but can also lead to the potential inheritance of the past tax liabilities. Another key factor in determining whether to use an asset or share deal in Vietnam is that the purchase of an asset is subject to VAT and the purchase of shares is not.

To be able to purchase Vietnamese assets, the buyer must establish a Vietnamese entity to hold the assets. Sales of assets are taxed at 20 percent of the gain, while share transfers can be taxed at either 20 percent of the gain or at 0.1 percent of the gross sale proceeds, depending on the type of shares being transferred and whether required conditions are met.

Advantages of asset purchases

— The full purchase price can be depreciated or amortized for tax purposes (including acquired goodwill).

— No previous liabilities of the company are inherited.

Disadvantages of asset purchases

— A foreign investor must have an entity in Vietnam to purchase the assets.

— Possible need to renegotiate supply, employment and technology agreements, etc.

— Benefits of any tax incentives and tax losses incurred by the target company remain with the seller (but may be lost altogether).

Advantages of share purchases

— Buyer may benefit from tax losses and tax incentives of the target company.

— Share purchases are not subject to VAT.

Disadvantages of share purchases

— Buyer is fully responsible for all past/inherent liabilities, including current tax and debts as well as any liabilities arising in the future as a result of past activities of the company.

Pre-sale dividend

In certain circumstances, the seller may prefer to realize part of the value of their investment as income by means of a pre-sale dividend. The rationale here is that after-tax retained earnings can be freely distributed to the corporate investor (in or out of Vietnam) without suffering further Vietnam withholding tax (WHT). Therefore, the dividend reduces the proceeds of sale and the gain on sale. As the rules in this area are not clear and interpretation by the local tax authorities is inconsistent, each case should be examined on its facts before entering a proposed transaction.

Annual remittance of dividends abroad may be made only where the company has completed the declaration of CIT for the relevant financial year, issued audited financial statements and received clearance from the tax office.

Profit and/or dividend remittance is not allowed where the financial statements of the target company show accumulated losses.

Exchange controls

All buying, selling, lending, and transfer of foreign currency needs to be made through credit institutions and other financial institutions authorized by the State Bank of Vietnam.

Outflow of foreign currency by transfer is authorized for certain transactions, such as payments for imports and services abroad, refund of loans contracted abroad and payment of accrued interests thereon, transfer of profits and dividends, and revenues from the transfer of technology.

Choice of acquisition vehicle

Several potential acquisition vehicles are available to a foreign buyer of a company in Vietnam, and tax factors often influence the choice. In addition to local foreign invested companies, the main types of vehicles for acquiring shares or assets in Vietnam include the following entities.

Local holding company

Foreign investors rarely use this vehicle as it is likely to require a license from the Vietnam authorities, which can be onerous and time-consuming to obtain. In addition, as there are currently no tax consolidation rules in Vietnam, there is no group tax benefit from including such a vehicle in the structure.

Foreign parent company

Foreign buyers normally choose to use a foreign parent company structure, which produces certain tax benefits. Dividends paid to foreign parent companies are not subject to Vietnamese WHT as long as they are paid from after-tax profits of the subsidiary.

Interest payments to a foreign parent company (i.e. shareholder loan) are subject to WHT at 5 percent. Other payments can enjoy lower WHT rates or exemption under tax treaties.

Tax clearances

A company is required to conduct tax finalization with the local tax authorities up to the time of the decision on the consolidation, division, merger, demerger or conversion that occurred prior to the transaction.

Repatriation of profits

After fulfilling all tax and financial obligations, foreign investors can repatriate their after-tax profit from Vietnam with no further WHT for corporate investors and with 5 percent WHT for individual investors.

A foreign parent company is subject to CIT of 20 percent on the gains arising from a sale of shares or WHT of 0.1 percent on the gross sale proceeds (when selling shares of a subsidiary, provided the shares are considered as securities under Vietnam law, i.e. the target is a public or listed company).

Foreign investors may seek a tax exemption on income from the transfer of capital in Vietnam under a tax treaty between Vietnam and the respective foreign country where relevant and subject to conditions

Non-resident intermediate holding company

An intermediate holding company resident in a favorable treaty territory is a popular structure for deals in Vietnam. However, attention should be paid to Vietnam's new anti-treaty shopping provisions, which were introduced in a circular that applies from 2014 and focuses on substance of the holding company and the transactions. Typical intermediate holding company jurisdictions include Singapore, Hong Kong (SAR), some European countries and low-tax jurisdictions.

Choice of acquisition funding

Debt

Investors may choose to fund their acquisition by debt arranged locally or from offshore.

However, for Vietnamese legal entities using debt to fund the acquisition, interest expenses incurred may not be deductible for Vietnam CIT purposes.

Under the domestic tax regulations, debt financing arranged locally does not attract WHT but CIT on income. However, for cross-border financing, an interest WHT rate of 5 percent applies. Of Vietnam's approximately 75 tax treaties currently in force, only the treaty with France provides tax exemption for interest on commercial loans. The other treaties generally specify a maximum interest WHT rate that is equal to or higher than the Vietnamese 5 percent domestic rate.

Deductibility of interest

Interest expenses are typically deductible against taxable income in the Vietnamese entities. There are no thin capitalization rules as such. However, an equity-to-debt ratio is specified in the investment certificate by virtue of specifying the charter capital (equity) and investment capital (debt capacity = total investment capital less charter capital). In the past, this ratio was restricted to 30:70. There is now no such restriction, but, in practice, it is difficult to convince the tax authorities to license a highly leveraged venture.

The tax-deductibility of interest is limited to 1.5 times the basic interest rate announced by the State Bank of Vietnam as of the date of the loan.

Under a newly issued decree on transfer pricing, tax deductions for loans from related parties interest are to be capped at 20 percent of EBITDA. The cap includes interest paid to third parties where related-party debt is present. If there is no related-party debt, there is no cap. Additionally, medium-and long-term foreign loans must be registered with the State Bank of Vietnam in order for the interest and related expenses to be deductible.

Interest payments on loans used as contributions to charter capital (equity) and interest payments made before a legal entity has commenced production and business are normally not deductible for CIT purposes.

Withholding tax on debt and methods to reduce or eliminate it

The interest payment on debt from a non-resident party to a Vietnamese party is subject to WHT at 5 percent, unless reduced under a tax treaty (likely only under France-Vietnam tax treaty).

Treaty relief is not automatically granted to beneficiaries, and no prior approval from Vietnamese tax authorities is granted. Professional advice should be sought to comply with requirements on tax treaty claims under both domestic laws and treaty provisions.

Hybrids

Hybrids are not used in Vietnam.

Deferred settlement

An acquisition often involves an element of deferred consideration, the amount of which can only be determined at a later date on the basis of the business's post-acquisition performance. Depending on the structure, the seller may only be exposed to Vietnamese taxation once income/gain from the future amount is realized.

Other considerations

There are a number of relevant rules that are subject to frequent changes, especially the rules related to standard VAT rate, capital gains tax rate and thin capitalization. Before proceeding with acquisitions, investors should seek professional advice on a range of related issues, such as foreign exchange control, repatriation of funds and limitations on foreign ownership.

Concerns of the seller

Corporate seller of shares/interest

Under CIT law, Vietnamese corporate sellers are ordinarily subject to 20 percent tax on any gain. Foreign corporate investors are subject to 20 percent tax on any gain (when selling the capital contribution in the subsidiary) or WHT of 0.1 percent on the gross sales proceeds (when selling shares of a subsidiary, provided the shares are considered as securities under Vietnamese law, i.e. the target is either a public or listed company).

Individual seller of shares/interest

Pursuant to the Law on Personal Income Tax (PIT), an individual seller is subject to tax on capital investment and capital assignment at the following rates:

Taxable income	Tax rate	
	Resident[1]	Non-resident[2]
Capital investment income (including dividends and interest)[3]	5 percent	5 percent
Capital assignment income (direct interest, i.e. holding an interest in a limited liability company)	20 percent on gains	0.1 percent on gross sale proceeds
Capital assignment income (securities where taxable gain can be determined)	20 percent on gains	0.1 percent on gross sale proceeds
Capital assignment income (securities where taxable gain cannot be determined)	0.1 percent on gross sale proceeds	0.1 percent on gross sale proceeds
Real estate transfer income[4]	2 percent on gross sale proceeds	2 percent on gross sale proceeds

Notes

1. This should include all offshore sourced income/gains/transactions.
2. Only on Vietnam-sourced income/gains/transactions.
3. Interest on deposit with credit institutions is classified as tax-exempt income.
4. Exemption applies on certain transaction such as sole dwelling property and family members' transaction, among others.

Source: KPMG in Vietnam

Company law and accounting

Company law

Vietnamese legal entities are mainly governed by two laws: the law on investment (LOI) and law on enterprise (LOE), as well as related regulations.

Vietnam does not have a specific company law as do many more developed jurisdictions. The law on enterprises (which includes partnerships and other business enterprises) does not have detailed provisions related to M&A activity.

Additionally, in Vietnam, the licensing of various activities by a range of government authorities can be time-consuming and administratively burdensome.

Vietnamese legal entities that are most relevant for M&A purposes take one of the following forms:

— multi-member LLCs

— single-member LLCs

— shareholding companies.

Under the LOE, enterprises may be divided, separated, consolidated, merged, converted or dissolved. Each entity is generally subject to corporate income tax of 20 percent on the net profits of the business (subject to a range of incentives).

Generally, new foreign businesses in Vietnam, except for banks and insurance businesses, are not required to set up and contribute after-tax profits to any compulsory reserves. Therefore, all after-tax profits can by fully remitted overseas.

While a foreign investor is entitled to contribute capital or purchase shares in Vietnamese companies, certain sectors and industries have government-imposed limits on the equity ownership allowed to foreign investors. The general principle is that both foreign and domestic business entities are entitled to make capital contributions, purchase shares or acquire interests in all companies in Vietnam, except for:

— public companies, including listed companies (49 percent cap remains in place)

— businesses operating in certain specialized industries

— equitized state-owned enterprises (SOE)

— specific limitations set out in Vietnam's commitments to the WTO for a number of industries.

Accounting standards

In Vietnam, Vietnamese accounting standard No. 11 predominantly determines the accounting treatment of business combinations. Generally, this standard should be applied to business combinations using the purchase method.

A business combination may be structured in a variety of ways. Under the accounting rules, this may involve the purchase by an entity of the equity of another entity, the purchase of all the net assets of another entity, the assumption of the liabilities of another entity, or the purchase of some of the net assets of another entity that together form one or more business. The transaction may be effected by the issue of equity instruments or the transfer of cash, cash equivalents or other assets, or a combination thereof.

An acquirer must be identified for all business combinations. The acquirer is the combining entity that obtains control of the other combining entities or businesses.

A business combination may result in a parent-subsidiary relationship, in which the acquirer is the parent and the acquiree is a subsidiary of the acquirer. In such circumstances,

the acquirer applies this standard in its consolidated financial statements. The parent includes its interest in the acquiree as an investment in a subsidiary in any separate financial statements issued by the parent.

Group relief/consolidation

There are no tax group relief or consolidation rules in Vietnam.

Transfer pricing

Vietnam transfer pricing rules are currently being aggressively enforced, especially for foreign entities, some of which the media perceive as abusing transfer pricing practices to evade taxes. From 1 May 2017, Vietnam's transfer pricing regulations are governed by Decree 20/2017/ND-CP, which extends the interpretation of existing provisions and introduces additional concepts and principles:

— Revised 'related-party relationship' definition: The new decree redefines 'related-party relationship' to exclude cases of input and output control (i.e. an enterprise sells more than 50 percent of its total sales or provides more than 50 percent of the raw materials or input products). In addition, the thresholds for some types of relationship are revised. For example, the threshold for the direct or indirect contributed capital ratio is increased to 25 percent (from 20 percent); the threshold on debt-to-equity ratio where an enterprise guarantees or loans funds to the other enterprise also increases to 25 percent (from 20 percent).

— Related-party transactions: Additional and new guidance is provided on the tax deduction of related-party transactions that are not in line with independent transactions, intergroup services fees and inter-company loan interest expenses.

— Use of comparables: The decree specifies the priority order for selecting comparables for benchmarking transfer prices as follows:

1. internal comparables of the taxpayers
2. comparables located in the same country or territory of the taxpayers
3. comparables located in the region that have similar industry conditions and levels of economic development.

The decree also clarifies the use of secret comparables versus commercial databases and public information/data and sets out clearer bases for the tax authorities to make transfer pricing assessment

Dual residency

Dual residency is not applicable in Vietnam.

Foreign investments of a Vietnamese company

In practice, outbound investment is not common as Vietnam is primarily an inbound investment destination. Some investments have been made into New Zealand, Laos, Cambodia, Myanmar primarily in dairy products, telecommunication and rubber plantations. The Vietnamese government sets specific rules for such activities, including a requirement for Vietnamese companies to obtain specific approval/permit from the licensing authorities to make investments overseas.

The Vietnamese company is required to repatriate to Vietnam all profits earned from investment projects within 6 months from the date of completion of the project, unless excepted by laws. Other detailed rules may also apply.

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Argentina

Introduction

From 2004 to 2006, the Latin American economy grew at a rate not seen since the late 1970s. The 2008 crisis contracted that growth but, since 2010, the rate of growth has recovered and economic strength has returned.

The Argentine Republic imposed tight controls on its foreign exchange market as of 2011, limiting the outflow of foreign currency through formal and informal regulations.

In theory, international acquisitions of Argentine entities may take the form of either the purchase of an equity participation in a target resident company or the purchase of the company's assets. In practice, most acquisitions by foreign corporations take the form of purchases of equity in the target resident company, so tax due diligence is an essential part of the due diligence process.

In Argentina, investors must bear in mind that merger and acquisition (M&A) transactions are evaluated according to anti-trust law as well as taxation rules. In addition, Argentine laws establish control mechanisms on actions or events that threaten free competition.

This report focuses on M&A-related issues that should be taken into account by parties entering M&A transactions in Argentina.

A new government took office in December 2015, and it is adopting important measures to normalize and boost the Argentine economy. The strict currency controls, trade protectionism and heavy taxes introduced by the former government from November 2011 to protect the country's low foreign reserves have been changed as follows:

— Export duties were eliminated, except for certain products.

— No prior approval from the Tax Authorities is needed to make cross-border transfers of funds.

— From 17 December 2015, a single exchange rate applies to all cross-border transactions, allowing the Argentine peso (ARS) to float with the intervention of the Central Bank.

— Restrictions on the ability to make transfers from Argentina to pay liabilities and investments abroad were reduced/eliminated. Commercial debt stock accumulated in the last 4 years may be paid off under a Central Bank program. The government also announced that it might issue a bond to cancel such commercial debt stock.

— Currency arising from new financial loans granted by non-residents to Argentine residents can be kept abroad.

— Principal loans transferred to Argentina can be repaid within 120 days after the transfer.

— The 30 percent mandatory deposit on foreign currency inflows was removed.

— No limits apply to amounts to be repatriated from foreign portfolio investments. However, such amounts need to be invested in Argentina for a period of time.

— No limits apply to the repatriation of foreign direct investment.

Recent developments

Tax treaties

The Argentine government issued Decree 1112/2017 (29 December 2017) enacting and making effective comprehensive tax reform. The changes introduced by the tax reform are aimed at promoting investment and competitiveness, and moving Argentina towards a more equitable, efficient, and modern tax system.

The tax reform measures include changes concerning the corporate income tax rates, dividend withholding tax, taxation of certain financial investments, indirect capital gains taxation, thin capitalization transfer pricing and fiscal transparency rules amongst others.

New tax treaties with Chile and Mexico were signed. The treaty with Chile entered into force on 1 January 2017, and the treaty with Mexico will enter into force on 1 January 2018.

Asset purchase or share purchase

An acquisition in Argentina usually takes the form of a purchase of the shares of a company, rather than its business and assets. An asset purchase is subject to income tax (and other taxes, such as valued added tax (VAT) and turnover tax). The buyers are jointly and severally liable, along with the tax debtors, for prior tax liabilities.

Purchase of assets

The acquisition of assets results in a stepped-up basis of the assets to the buyer. However, the step-up is limited to the market value of the assets. The sale price is allocated to the assets, tangible and intangible, net of liabilities. Any additional consideration is attributed to goodwill, which is not deductible for tax purposes.

The asset purchase establishes a limit on the co-responsibility of buyers for non-declared fiscal and social security liabilities, as long as they comply with the requirements in Section 8 subpart d) of Law No. 11683 to report the transaction to the national fiscal authority. In practice, sellers rarely agree to report the asset transfer because such notification may prompt the tax authorities to subject the seller to a tax examination.

Thus, it is advisable to perform due diligence on the owner of the asset to be sold to estimate the contingencies that could transfer to the buyer. In defining the scope of the tax due diligence process, bear in mind that the statute of limitations for tax liabilities is generally 5 years.

However, there is no statute or regulation that limits the tax authorities' power to examine open periods, even those already examined, so the tax due diligence process should cover all open tax years, whether or not examined.

Purchase price

For tax purposes, it is necessary to apportion the total consideration among the assets acquired. It is generally advisable for the purchase agreement to specify the allocation. Normally, this allocation is acceptable for tax purposes, provided it is commercially justifiable. The purchase price of inventories and fixed assets should be calculated based on their market value. It is advisable that such valuation should be prepared by an independent valuations professional.

Goodwill

Generally, the tax treatment of intellectual property and other intangible assets is aligned with their accounting treatment. Amortization of goodwill, trademarks and similar intangible assets is not deductible.

At the taxpayer's option, reorganization costs may either be deducted in the year incurred or capitalized and amortized over a period not exceeding 5 years.

Depreciation

Depreciation of buildings used to generate taxable income may be deducted at a 2 percent annual rate on the cost of the buildings. Other depreciation rates may be used if they are technically supported.

Annual depreciation of all other depreciable assets used to generate taxable income is determined by dividing the acquisition cost of the asset by its estimated years of useful life. The tax law does not include standard depreciation rates.

Other depreciation methods, such as those based on units of production or time of use, may be used where they are technically justified.

Tax attributes

Tax losses and other tax attributes (e.g. industrial promotional benefits) are not transferred on an asset's acquisition. They remain with the seller because the law does not permit their transfer unless the asset deal is organized as a tax-free operation (i.e. transfer of assets among the same economic group, subject to certain legal requirements). See the section on tax losses on share purchases later in this report.

Value added tax

VAT is levied on a large number of goods and services, although goods and services exported from Argentina are zero rated. The seller charges VAT (output VAT) to the buyer on the transfer of inventories, fixed assets and movable goods. The buyer can use the input VAT as a fiscal credit to offset future VAT charged to customers on domestic transactions, as long as the buyer is registered for VAT purposes in Argentina.

The standard VAT rate is 21 percent. A reduced rate of 10.5 percent applies to the sale of certain capital goods. Although goodwill is not subject to this tax, it may be taxed where it is tied to taxable services rendered as part of the general transaction.

Transfers of goods are exempt from VAT in the case of a tax-free reorganization.

The transfer of a business as a going concern could be treated as VAT-free, provided the transfer is organized as a VAT-free transfer within the same economic group and certain legal requirements are met. Professional advice should be sought where buildings are being sold because complications may arise if the sale occurs within 10 years of acquisition (or completion of construction). Section 11 of the VAT Law prescribes that tax credits computed on time will be refunded.

Transfer taxes

The sale of assets may trigger a turnover tax for the seller. Generally, the tax applies to the transfer of inventories. Transfers of accounts receivable, fixed assets and intangible

assets are not usually subject to turnover tax in the same way as transfers of goods when a tax-free reorganization treatment applies (see 'Reorganizations').

The turnover tax is a state tax collected by the city of Buenos Aires and other provinces. However, there is the equivalent of a tax treaty among all local jurisdictions to avoid double taxation.

The turnover tax base is similar to that of VAT, but the turnover tax does not generate a tax credit. Turnover tax rates vary among the provinces, ranging from 2.5 percent to 4.0 percent. A reduced rate of 1.5 percent or an exemption may apply in a province where a factory is located.

The stamp duty is a provincial tax levied on legal transactions expressly provided for by statute. Such transactions are documented with public or private instruments. Generally, the stamp duty is assessed at a rate of 1 percent and is applied on the economic value involved in the transaction. The parties signing the agreement/instrument are jointly liable for the payment of the tax.

Transfers of assets are generally subject to the stamp duty when the transfer is completed with a written agreement.

Purchase of shares

Shares in a resident Argentine corporation may be purchased through an existing or newly created local subsidiary of the foreign acquiring corporation. The acquisition may be financed by the subsidiary's own funds or through loans from the parent foreign corporation or a third party, such as a bank.

Generally, a foreign entity acquires a target Argentine company directly. The deductibility of interest on acquisition debt may be in doubt when a resident holding company structure is used.

Buyers of stock in an Argentine company cannot obtain a step-up in the tax basis of the assets purchased.

Tax indemnities and warranties

Most acquisitions in Argentina are stock purchases.

In a stock purchase, buyers become fully liable for the tax liabilities of the target company until the end of the statute of limitations period. It is customary for the buyer to initiate a due diligence exercise, which normally incorporates a review of the target's tax affairs.

In defining the scope of the tax due diligence process, bear in mind that the statute of limitations for tax liabilities is generally 5 years. As noted, however, there is no statute or regulation that limits the tax authorities' power to examine open periods, even those already examined. The tax due diligence process should cover all open tax years, whether or not examined.

The party acquiring the shares of a company usually requests a guarantee that, by buying its shares, the buyer is also inheriting the company's tax history. As a result, after the due diligence process — with a subsequent purchase audit — an escrow account generally is opened on the buyer's behalf in case of contingencies. The Argentine tax authorities do not grant clearance certificates stating that a particular taxpayer has no tax outstanding.

Tax losses

Net operating losses may not be carried back but may be carried forward for up to 5 years.

Foreign-source losses are subject to an additional limitation as they may offset only foreign-source income. A similar restriction applies to losses on sales of shares, treasury bonds and certain derivatives transactions.

Changes in the shareholder do not remove the possibility of offsetting the tax losses with taxable earnings of the entity that owns the tax losses.

Under a tax-free reorganization, tax attributes, such as loss carry forwards, can be conveyed from the predecessor company to the surviving company. Tax loss carry forwards (and unused tax exemptions/promotional benefits) are only transferable to the surviving company or companies when the holders of record of the predecessor company or companies retained at least 80 percent of their capital contributions in these companies (unless the shares are traded under self-regulated stock markets) for at least 2 years prior to the date of the reorganization.

Transfer taxes

The stamp duty is a provincial tax levied on legal transactions expressly provided for by statute. Such transactions are documented with public or private instruments. Generally, the stamp duty is assessed at a rate of 1 percent of the economic value of the transaction. The parties signing the agreement/instrument are jointly liable for the payment of the tax.

Transfers of shares or interests held in business organizations (e.g. limited liability companies — SRL) are subject to the stamp duty, provided generally that the transfer is completed with a written agreement.

Choice of acquisition vehicle

The purchase of shares in a resident Argentine corporation may be made through either an existing or newly created local subsidiary of the foreign acquiring corporation. Tax factors often influence this choice.

There is no stamp tax on the introduction of new capital into an Argentine entity.

Local holding company

An Argentine company could be used where the buyer already owns another entity located in Argentina.

However, capital gains arising from the disposal of shares of an operating company are taxable at the level of the resident holding company, and the deductibility of interest on acquisition debt may be in doubt where a resident holding company structure is used.

Rules and consequences for foreign shareholders

Supervisory Board of Companies

General Resolution No. 7/2015, issued by the Supervisory Board of Companies (IGJ), is intended to prohibit the registration of foreign companies that do not effectively conduct business or own assets outside of Argentina but whose sole purpose is to conduct business activities in Argentina. The resolution may require non-Argentine companies to incorporate as Argentine companies before registering them with the IGJ as shareholders of Argentine corporations domiciled in the city of Buenos Aires.

Incorporation as an Argentine company is required where the foreign investor cannot prove that the value of its non-Argentine non-current assets is significant when compared to the value of its ownership interest in the Argentine company.

Note that there must be a minority shareholder holding at least 5 percent of the Argentine company or the company can be re-classified as a branch. In addition, the new Civil and Commercial Code in force since August 2015 allows the incorporation of company with a single shareholder.

Special-purpose vehicles

Special-purpose vehicles (SPV) that do not strictly comply with Resolution No. 7 may still be registered as foreign, provided they can demonstrate that the ultimate controlling company of the group complies with the resolution (i.e. has significant assets outside Argentina).

The SPV must submit a certificate stating that its sole purpose in seeking registration is to serve as an SPV of the controlling company. The certificate must be accompanied by documents issued by the boards of directors, management or governing bodies of the SPV and the controlling company. For this purpose, an affidavit executed by the legal representative of the SPV is required with:

— a corporate organizational chart of the chain of companies that control the SPV

— certain information about the shareholders of the SPV and the SPV's parent.

Equalization tax

Dividends are non-taxable where the amount distributed does not exceed the cumulative taxable income. Any excess is subject to a withholding of 35 percent as a one-off final payment. Stock dividends are not subject to withholding.

Specifically, under the Income Tax Law, when individuals and taxable entities (e.g. corporations, branches, partnerships) pay dividends or distribute earnings in cash or in kind exceeding Argentine taxable income accumulated at the end of the fiscal year before the payment or distribution, 35 percent of the excess amount will be withheld as one-off payment.

However, this 35 percent 'equalization tax' is repealed for earnings accrued on or after 1 January 2018.

The 10 percent WHT applies on gross dividends paid to Argentine individuals or foreign shareholders was abrogated by Section 75 of the Law No. 27260. However, an additional WHT is levied on distributed dividends or profits, bringing the total tax rate to 35 percent, as follows:

— 7 percent dividend WHT rate for distributions on profits accrued for tax years from 1 January 2018 to 31 December 2019

— 13 percent dividend WHT rate for distributions on profits accrued for tax years starting on or after 1 January 2020.

Note that corporate income tax rate will be gradually reduced according to the following schedule:

— 2018 and 2019: 30 percent

— 2020 and after: 25 percent.

Therefore, for the 2 fiscal years starting 1 January 2018, the effective final tax rate would be 34.9 percent: 30 percent (corporate rate) plus 7 percent (WHT on dividends paid to Argentine resident individuals and foreign beneficiaries).

For fiscal years starting on or after 1 January 2020, the effective final tax rate would be 34.75 percent: 25 percent (corporate rate) plus 13 percent (WHT on dividends paid to Argentine resident individuals and foreign beneficiaries).

Tax-efficient shareholders

It is essential to structure the acquisition of a target company in Argentina so as to minimize taxes applicable to cash exchanges between the Argentine target company and the foreign-related companies.

Currently, Argentina has tax treaties in force with 18 countries: Australia, Belgium, Bolivia, Brazil, Canada, Chile, Denmark, Finland, France, Germany, Italy, Mexico, Netherlands, Norway, Spain, Sweden, United Kingdom and Russia.

The treaties grant various tax benefits to the foreign beneficiary generating Argentine-source income, such as reduced income tax withholding on the payment of dividends or interest. The treaties also establish rules for determining the deductibility of such payments by the local taxpayer.

Non-resident intermediate holding company

If the foreign country taxes capital gains and dividends received from overseas, an intermediate holding company resident in another territory could be used to defer this tax and perhaps take advantage of a more favorable tax treaty

with Argentina. However, the buyer should be aware that Argentine treaties contain treaty-shopping provisions that may restrict the ability to structure a deal in a way designed solely to obtain tax benefits.

Direct transfer of shares

In case of sale of shares of an Argentine company derived by non-residents, there are two options to calculate the capital gain (election is made by seller): domestic 13.5 percent on gross or 15 percent on the capital gain taxation. Provisions of double tax treaty should be considered.

The law establishes that the foreign seller, through a representative appointed in Argentina, is the responsible party for paying the tax. This should be further regulated.

Indirect transfers by non-residents

Based on the tax reform established by Law 27430, a non-resident is deemed to obtain Argentine-source income from the sale of shares, units, interests, securities convertible into shares or any other right representing the capital or equity of the entity, fund, trust or equivalent entity, permanent establishment, appropriated equity or any other entity established, domiciled or located abroad, when the following conditions are met:

- The market value of shares, interests, units, securities or rights held by such seller in the entity located abroad, at the time of sale or during the previous 12 months, accounts for at least 30 percent of the current market value of the Argentine assets directly or indirectly owned by the referred seller. Such assets include:
  - shares, rights, units or other interests in ownership, control or earnings of a company, fund, trust or any other entity established in Argentina
  - permanent establishments in Argentina that are owned by one person or entity not residing in the country
  - other assets of any nature located in Argentina or any interests such assets.
- Shares, interests, units, securities or rights sold that, at the time of sale or during the previous 12 months, account for at least 10 percent of the equity of the foreign company that directly or indirectly owns these assets.

The tax does apply participations in foreign entities acquired after the law's effective date of 29 December 2017.

Local branch

As an alternative to an Argentine holding company, a foreign buyer may structure the acquisition through an Argentine branch. Argentina does not impose additional taxes on branch profits remitted to an overseas head office. Argentine branches and corporations are taxed similarly at the national and provincial levels.

If the Argentine operation is expected to make losses initially, a branch may be advantageous. Subject to the tax treatment applicable in the head office's country, a timing benefit could arise from the ability to consolidate losses with profits of the head office.

Joint venture

Joint venture structures are not commonly used in Argentina.

Choice of acquisition funding

A buyer using an Argentine vehicle to carry out an acquisition for cash needs to decide whether to fund the vehicle with debt or equity. The principles underlying these approaches are discussed later in this report.

Debt

The principal advantage of debt is the potential tax-deductibility of interest (see 'Deductibility of interest').

Leveraged buy-outs

In a leveraged buy-out, a new holding company, the acquiring company, typically does not have sufficient capital to acquire the target company, so it arranges to take out a loan from a financial institution or related party.

Where the transaction is limited to the acquisition of capital stock or the merger of the new holding company with the target company, and the acquiring company's indebtedness is transferred to the target company, then the transaction is characterized as a leveraged buy-out merger. In these circumstances, the target company seeks the interest deduction for the loan, provided that the target has high and stable cash flows. However, the tax authorities have determined that interest arising from loans taken out to finance the purchase of shares is not tax-deductible.

The Argentine tax laws do not have special provisions on financial leverage or leveraged buy-outs. The current provisions on the deduction of interest apply. As a general rule, interest is deductible to the extent that it is related to the generation of taxable income. There are also capitalization rules applicable to loans granted by foreign-related entities under certain conditions.

In Opinion No. 62/03, the tax authorities considered interest accrued in connection with the purchase of the majority of the capital stock of a company that was then absorbed (leveraged buy-out merger). The tax authorities concluded that the purchase was not a part of the merged company's activities (operating activities) and that the interest was not deductible.

In a later decision, the National Special Tax Court held that "interest accrued from loans taken out to acquire the aggregate capital stock of a company before the merger of such company is an expense which is not necessary to obtain income or maintain the source of income of the company. Therefore, any such interest is not deductible. It is an investment made by the shareholder and, thus, it is

the shareholder who will be subject to any applicable tax consequence".

Thin capitalization rules

For tax years starting on or before 31 December 2017, Argentina's thin capitalization rules applied to interest on loans granted by foreign related financial institutions to local companies, denying interest deductions where the debt-to-equity ratio of the local company exceeded a 2:1 ratio. Interest that was not deductible as a result of this rule would be re-characterized as a dividend and treated accordingly. In the case of a treaty country intercompany loan, the thin capitalization rules may not apply, even where the 2:1 equity ratio is exceeded (although opinions differed on this issue).

Although not necessarily a proper practice, the Argentine tax authorities previously sought to apply a regulatory decree stating that interest (other than on loans subject to the 35 percent WHT rate) is not deductible when the debt-to-equity ratio exceeds a 2:1 ratio and should be re-characterized as a dividend. As a result, interest generated by a treaty country intercompany loan may be subject to thin capitalization rules where the 2:1 equity ratio is exceeded.

Based on the above, leverage could be introduced to a target Argentine company by borrowing capital from lenders in treaty countries and also in non-treaty countries, as long as the 35 percent domestic WHT rate can be claimed as a tax credit in the foreign non-treaty country.

For tax years starting on or after 1 January 2018, the tax reform introduced by Law 27430 modifies the regime by providing a new limitation for the deduction of interest arising from financial loans (regardless of the origin) and replacing the previous debt-to-equity ratio exceeding 2:1. Now this limit is the greater of the 30 percent of earnings before interest, taxes, depreciation and amortization (EBITDA) and an amount to be fixed by the executive authority.

Where the deductible interest amount is less than the deductibility threshold, the unused deduction can be carried forward for 3 tax years.

Similarly, where the interest amount exceeds the limit established, the difference can be carried forward for 5 tax years.

This limitation does not apply if the taxpayer can prove that, for the applicable tax year, the ratio between the interest and the net income of the Argentine taxpayer is lower than or equal to the same ratio applicable for its economic group in relation to debts with unrelated creditors.

Deductibility of interest — temporary limitation

Under section 18 of the Argentine Income Tax Law, interest payments are expenses incurred by local companies holding foreign capital. Such expenses become Argentine-source taxable income for a foreign company that participates, either directly or indirectly, in its capital, control or management, and/or for an entity located in a tax haven. Therefore, the relevant recording in the financial statements for tax purposes can only be made when the expenses are paid within the term fixed for the filing of the tax return of the fiscal year in which the corresponding disbursement accrued (5 months following year-end date).

Hence, where an Argentine holding company does not pay the interest within such term, the interest is not deductible in the financial statements for tax purposes (otherwise, it is deductible in the year paid).

General Instruction Number 747

With General Instruction Number 747, the Argentine tax authorities attempted to challenge the deductibility of interest and exchange gains/losses arising from loans in foreign currency between companies located in Argentina and foreign companies.

Reasons for these challenges included the lack of a formal agreement between the parties, failure to state the terms for the repayment of principal and/or interest, and failure to include an interest rate in the loan agreement.

In addition, it is important to meet the formal requirements discussed above in the event of leveraged buy-outs to avoid the possibility that the tax authorities may challenge the exchange gains/losses and interest derived from these loans.

Fiscal transparency rules

Non-cooperative and low or zero taxation jurisdictions

The new rules in Law 27430 introduce definitions of 'non-cooperative' and 'low-tax or zero-tax jurisdictions'.

'Non-cooperative jurisdictions' include any country or jurisdiction that has not entered into an agreement for the exchange of information on tax matters or a tax treaty that provides for the broad exchange of information with Argentina. In addition, countries that have entered into such agreements but do not effectively comply with the exchange of information clause are also considered as non-cooperative countries or jurisdictions. The Argentine executive branch is expected to prepare a list of non-cooperative jurisdictions based on the new criteria.

'Low-tax or zero-tax jurisdictions' include countries, domains, jurisdictions, territories or associated states or special tax regimes with a maximum tax rate on corporate income that is below 60 percent of the Argentine rate.

Fiscal transparency rules apply to Argentine companies or individuals that hold shares or interest ownership in foreign companies located in these jurisdictions, under certain conditions.

Taxpayers participating in transactions with entities located in non-cooperating or low-or no-tax jurisdictions may need to analyze the consequences of those transactions from an Argentine transfer pricing standpoint, as well as the special deductibility rules and exclusions from capital gains exemptions, among others.

Payment of withholding tax

Where WHT owing is not paid, the expenses (interest) are not tax-deductible.

Transfer pricing

Under transfer pricing provisions, interest on borrowings between a local company and a foreign-related company must conform to normal market practices on an arm's length basis.

New rules enacted by Law 27430 affect all imports and exports involving an international intermediary where the intermediary is a related party or the foreign counterparty is related to the Argentine importer or exporter. The intermediary's fee is determined based on the risks assumed, functions and assets involved. The price must be justified with the most appropriate method.

For exports of goods with known prices, an agreement registration is mandatory where the transactions involve an Argentine exporter and an international intermediary who is either a related party or located in a zero-tax, low-tax or non-cooperative jurisdiction (discussed above).

WHT on debt and methods to reduce or eliminate it

A WHT is imposed on payments of interest to non-residents at the following rates:

- 15.05 percent where the borrower is a local financial entity, the loan is related to the financing of capital goods imports, or the foreign creditor is a financial or banking institution located in a country that either:
  - is not considered a low-tax jurisdiction
  - has a treaty with Argentina that contains an exchange of information clause that has no local restrictions regarding information exchange between revenue services.
- 35 percent for all other cases.

However, interest from the following portfolio investments is not taxed if paid to non-residents:

- obligations of the Argentine government
- obligations (bonds) issued by resident corporations and other non-government entities through a public offer.

The existing tax treaties may set lower WHT rates for payments to recipients in the relevant countries.

To obtain WHT relief under a treaty, the foreign beneficiary should submit an affidavit demonstrating that it is a foreign resident, according to General Resolution 3497. The related foreign tax authorities must certify the data in the affidavit, and it must be in line with the Hague Apostille regime.

Checklist for debt funding

- The tax authorities have determined that interest on loans taken out to finance the purchase of shares cannot be deducted for tax purposes.
- The use of bank debt may avoid thin capitalization and transfer pricing problems.
- Meet formal requirements of loans to avoid a possible tax authority challenge regarding the exchange gains/losses and interest derived from these loans.
- Deductibility of interest from related companies is conditional on the effective payment of such interest.
- Thin capitalization rules only apply to any related party loan regardless of whether the entities are local or foreign ones. The new limit for the deduction of interest on financial loans is 30 percent of EBITDA or an amount fixed by the executive authority, whichever is higher.

Equity

Foreign companies usually structure inbound investments into Argentina by using a portion of debt and a portion of equity.

Stamp tax is not applicable to new shares and/or to capital contributions.

Reorganizations

Tax-free reorganizations may be structured under an Argentine law that allows tax attributes, such as loss carry forwards, to be conveyed from the predecessor to the surviving company.

Tax loss carry forwards and unused tax exemptions are only transferable to the surviving company or companies where the holders of record of the predecessor company or companies held at least 80 percent of their capital contributions in these companies (unless the shares are traded under self-regulated stock markets) for at least 2 years prior to the date of the reorganization.

Argentine law defines 'reorganization' as:

- the merger of pre-existing enterprises
- the division of an enterprise into another or others that continue, together, the operation of the first enterprise
- the sale or transfer of one entity to another that, although being legally independent, constitute the same economic whole.

For a reorganization to qualify for tax-free treatment, certain requirements must be satisfied. For example, the holder(s) of record of the predecessor company must retain an investment in the surviving company equal to the investment in the predecessor company for at least 2 years from the date of the reorganization. The reorganized companies must have had the same or related activities during the 12 months preceding the merger, and each company must have existed for at least 18 months before the reorganization. The surviving entity must continue its activities for at least 2 years after the date of the reorganization, so that the goods and/or services the surviving company or companies produce and/or trade have characteristics similar to those of the predecessor company or companies.

The reorganization must be communicated to the tax authorities within 6 months of the reorganization date.

M&A transactions are evaluated according to anti-trust laws where they involve economic concentrations through mergers, going-concern transfers, acquisitions of interests in other companies that confer control over them, and transfers of assets that also confer control or a dominant influence on decision-making.

Hybrids

Hybrids, which are instruments treated as equity in the accounts of one party and as debt in the accounts of the other, are not applicable for Argentine income tax purposes.

Discounted securities

No special Argentine tax benefits arise in connection with the issuance of securities issued at a discount.

Other considerations

Labor issues

Where a business is transferred by whatever means, all the obligations arising from the employment contract between the transferor and the employee at the time of the transfer are transferred to the transferee or buyer, including those resulting from the transfer itself. The employment contract remains in full force and effect with the transferee or buyer, and the employee retains the rights vested in all the years of service with the transferor. The transferor and transferee of a business are jointly and severally liable for the related obligations arising from the employment contract at the moment of the transfer.

Sale of shares of stock corporations or quotas of limited liability companies

Under the tax reform enacted on 23 September 2013, capital gains derived by non-residents from the sale of shares or quotas are subject to either a 15 percent tax on gross proceeds or a 13.5 percent tax on net proceeds (at the taxpayer's option). Where net proceeds are chosen, the Argentine tax authorities should validate the costs.

The buyer is responsible for collecting the tax. However, regulations for the collection mechanism are still pending.

Sale of interest in limited liability company

The sale of an interest in a limited liability company is treated the same way as a sale of shares.

Company law and accounting

Mergers are regulated by Corporations' Law 19550 (ACL), and acquisitions of shares/quotas are regulated by the Civil and Commercial Codes.

ACL foresees two types of mergers: a pure or simple merger where two or more companies are dissolved (without liquidation) in order to create a new one, and an absorption merger where an existing company incorporates one or more other companies that are dissolved without being liquidated.

To effect a merger, several steps must be performed:

— preparation of special merging financial statements

— board of directors' meeting approving the merger

— signing of a preliminary merger agreement (*v.gr. Compromiso Previo de Fusión*)

— extraordinary shareholders' meeting

— publication of legal notices in the Official Gazette and other main newspapers

— signing of the definitive merger agreement (*v.gr. Acuerdo Definitivo de Fusión*)

— registration before the respective Public Registry of Commerce of Buenos Aires City.

ACL allows mergers of different types of companies. It is possible to merge corporations with limited liability companies or commercial and civil entities.

The practical advantage of carrying out a reorganization procedure (merger) rather than an acquisition of shares/quotas is that the companies involved do not need liquidity to merge. When acquiring shares/quotas, the buyer must either have liquidity or obtain financing.

To effect a merger, special merging financial statements must be prepared, which must be audited by a local certified public accountant (CPA). Legal notices and accounting documents must also be prepared.

Third parties and creditors are specially protected by ACL. Before signing the definitive merger agreement, creditors could oppose the merger procedure and request their debts be paid, and corresponding judicial recourses are available to them.

Once all requirements have been fulfilled, the documents must be filed before the respective Public Registry of Commerce of Buenos Aires City. Once registered, third parties can still oppose the merger.

Where a merger (or acquisition of shares/quotas) amounts to an abuse of a dominant position in a specific market (or is alleged to do so), the operation (merger or acquisition of shares/quotas) must be submitted to and approved by the Anti-Trust Commission in advance. Failure to request such authorization could lead to fines or the prohibition of the merger or acquisition of shares/quotas.

Where shares/quotas are acquired, a purchase agreement must be entered into by the parties and the seller must notify its participants so that they can modify and update their registrations.

Where quotas of a limited liability company are acquired, the purchase agreement must be registered with the Public Registry of Commerce of the relevant jurisdiction and a legal notice must be published in the Official Gazette.

Foreign companies participating in a merger or acquisition procedure must be registered with the Public Registry of Commerce of the relevant jurisdiction under section 123 of the ACL (foreign entity registered to participate as a shareholder/partner of a local company) or section 118 of the ACL (branch of a foreign company) under the penalty of not registering the acts of the participating local companies. Every local jurisdiction also has administrative requirements for foreign companies.

From an accounting viewpoint, it is necessary to distinguish transactions between unrelated parties (business combinations) from transactions within the same economic group (corporate reorganizations) because the accounting treatment depends on this distinction.

For a business combination, both assets and liabilities are stated at fair market value. If there is a difference between fair market value and the price paid, positive or negative goodwill arises. If the useful life of goodwill is indefinite, it is not amortized but annual recoverability analysis is required.

For a corporate reorganization (within the same economic group), assets and liabilities are added to the book value and no goodwill arises.

Group relief/consolidation

Consolidated filing is not permitted. Each entity, even where it belongs to the same owner or affiliated group, must file a separate tax return.

Transfer pricing

Argentina's transfer pricing regulations are broadly comparable with Organisation for Economic Co-operation and Development (OECD) guidelines.

There is, however, no hierarchy for the application of the OECD's accepted transfer pricing methods in Argentina. The selection of the appropriate method depends primarily on the availability of information and the number and magnitude of the adjustments necessary to achieve comparability.

Under these provisions, compensation for services between a local company and a foreign-related company must conform to normal market practices on an arm's length basis. If not, the tax authorities may make appropriate adjustments, by applying methods and procedures prescribed by the law, to the tax return of the local company, and thus increase its taxable base.

The transfer pricing return (i.e. report certified by a CPA) must be filed 8 months after year-end. Under section 15.1 of the Income Tax Law, failure to file the tax returns and related transfer pricing analyses with the tax authorities may result in fines of up to 6,000 US dollars (US$) for each tax return not filed.

Foreign investments of a local target company

For resident corporations, worldwide income is taxable, including the income of foreign branches and subsidiaries, even where such income is not repatriated. Income of foreign subsidiaries is taxable only to the extent of dividends actually paid. However, where the subsidiary is organized in a tax haven country, the Argentine company is taxed on its allocated share of the subsidiary's income, regardless of whether a dividend is paid.

Comparison of asset and share purchases

Advantages of asset purchases

— Limits the co-responsibility of buyers for non-declared fiscal and social security liabilities, as long as they comply with Law No. 11867 and report the transaction to the tax authorities.

— The purchase price, or a portion of it, can be depreciated or amortized for tax purposes.

— Possible to acquire only part of a business.

Disadvantages of asset purchases

— Higher transfer taxes apply (VAT, turnover tax, etc.).

— Benefits of cumulative tax losses incurred by the seller remain with the seller, because the law does not permit their transfer.

Advantages of share purchases

— May benefit from tax losses of seller's company.

— Lower transfer taxes apply to the operation (no VAT, no turnover tax, etc.) compared to asset purchases.

— Lower capital payments compared to asset purchases.

Disadvantages of share purchases

— Buyer assumes all the tax and social security history of the company.

— Buyer remains liable for any claims or previous liabilities of the entity, including tax, social security and labor obligations.

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Brazil

Introduction

Despite internal economic challenges and slower global economic growth than forecast, Brazil remains attractive for foreign investors because of a variety of economic factors, including its relative economic and political stability, control over inflation, and large and growing consumer market.

Like other Latin American countries, Brazil has made significant strides in amending its tax legislation to attract direct foreign investments.

Brazil's government recently announced a sweeping privatization program involving 57 projects. On 29 May 2017, Brazil formally asked the Organisation for Economic Co-operation and Development to become a member of the organization, and the OECD is evaluating the request.

The Brazilian mergers and acquisitions (M&A) environment is dynamic. Tax laws are subject to frequent changes, creating not only pitfalls that can frustrate M&A tax advisors but also tax planning opportunities. Further, although Brazilian tax law often seems inflexible, it offers significant flexibility for Brazilian tax planning.

Good acquisition due diligence is important everywhere, and particularly in Brazil. The complexity of the tax system, the high amount of tax litigation necessary to resolve tax issues and protective labor regulations, among other issues, can complicate the evaluation of Brazilian targets and negotiations significantly.

A number of potentially significant tax issues are not yet identified or assessed by the tax authorities or tested in the courts, including:

— informal practices, such as income not recorded and false invoices in the accounts

— outsourced or unregistered employees

— doubtful or aggressive tax planning

— low quality of financial information and controls

— inclusion of private/shareholders' interests with the company's interests

— frequent tax law changes and increases in the tax burden

— high number of tax lawsuits

— succession risk.

Overall, there is a relatively high tax burden in Brazil, with complex and interrelated tax provisions. Good tax planning is essential for the parties involved in any M&A project in Brazil.

Recent developments

New accounting rules

With the introduction of Law 11,638/07 in 2008, Brazil took its first steps toward adopting international accounting standards. This created a complex situation because of the differences between existing and forthcoming rules based on these international standards and the old Brazilian generally accepted accounting principles (GAAP). To mitigate the effects of these differences and provide taxpayers with general guidelines, the Brazilian government issued a special regulation at the end of 2008.

The main object of this regulation (Law 11,941/09) was to provide temporary tax-neutrality for the new accounting rules (i.e. changes in accounting rules should not affect corporate tax calculations). The provision caused a number of uncertainties for taxpayers as certain aspects of the legislation were not clear (i.e. whether goodwill deduction should take into consideration the purchase price allocation or be calculated under the old accounting rules).

However, this temporary tax-neutrality was repealed with the enactment of Law 12,973 in 2014. Among several other changes, the new law effectively aligned Brazilian tax accounting with International Financial Reporting Standards (IFRS).

In relation to cross-border transactions, especially those directly or indirectly connected to M&A processes; the new legislation considerably affects the rules for recording

and deducting the goodwill generated in the acquisition of investments, payment of dividends and payment of interest on net equity.

Measures to address base erosion and profit shifting

Initial guidance on dispute resolution

Normative Ruling (NR) 1,669/2016 (published 10 November 2016) aims to regulate dispute resolution under Brazil's network of international tax treaties and conventions for the avoidance of double taxation, in accordance with Action 14 of the OECD's Action Plan on Base Erosion and Profit Shifting (BEPS), which aims to making dispute resolution mechanisms more effective.

The main aspects under NR 1,669/2016 are as follows:

— All taxpayers can open a consultation process if they identify tax measures that result in double taxation.

— Where the resolved dispute results in a tax credit, the taxpayer would request the refund through a specific administrative procedure.

— The tax administration would issue an implementation order that validates the resolution (even if the resolution resolves only part of the dispute).

— Before the resolution is implemented, the parties must agree to it and withdraw any related pending appeals or lawsuits.

Country-by-country reporting

The mandatory annual filing of country-by-country (CbyC) reports in Brazil was introduced in Normative Instruction 1,681, issued by the Federal Tax Authorities on 29 December 2016.

CbyC reports must be filed by companies that:

— are resident for tax purposes in Brazil and the ultimate parent company of a multinational group; if the ultimate parent company is non-resident, the entity resident in Brazil may be required to transmit the declaration where:

  — the ultimate parent is not required to file a CbyC report in its jurisdiction

  — there is no bilateral competent authority agreement between the foreign jurisdiction and Brazil, or

  — there has been a systemic failure.

— earn total consolidated group revenue, in the fiscal year before the year of the declaration, in an amount greater than:

  — 2.26 million Brazilian real (BRL) if the ultimate parent is resident in Brazil, or

  — 750,000,000 euros (EUR) or the equivalent in local currency if the ultimate parent is non-resident.

The CbyC report is to be filed along with the taxpayer's corporate income tax return for the related year.

Tax treaties

Brazil has signed tax treaties with an extensive number of countries, and these treaties generally provide relief from double taxation through foreign tax credits.

Existing treaties offer few opportunities to reduce or eliminate withholding taxes on payments abroad. Additionally, tax sparing clauses are found in most treaties in force.

Updates on Brazilian treaties: India, Spain and Russia

Brazil is participating in the OECD's international BEPS project and has formally asked to become an OECD member.

In light of this recent interest in international taxation, the Brazilian Senate approved two treaties and treaty amendments, as published in the Official Gazette on 26 May 2017:

— *Brazil — India Double Tax Treaty (1988)*: The tax treaty between Brazil and India was signed in 1988 and has been in force in Brazil since 1992. On 15 October 2013, the parties signed protocol to amend and update Article 26 of the treaty on exchange of information. The protocol was approved by the Brazilian Senate through Legislative Decree 81/2017.

— *Brazil — Spain Agreement for the Mutual Exchange and Protection of Classified Information*: Brazil and Spain have had a tax treaty in place since 1976. Their new treaty deals only with the mutual exchange and protection of classified information between Brazil and Spain. The new treaty was signed on 15 April 2015, and it was approved by the Brazilian Senate through Legislative Decree 82/2017.

For both new agreements, the next step in the ratification process in Brazil is approval by executive decree, to be signed by the president.

The tax treaty between Brazil and Russia took effect internally in Brazil as of 1 August 2017, when the Presidential Decree 9,115/2017 enacting it was published in the Official Gazette. Although the treaty was signed in 2004, it was only considered by the Brazilian Senate in 2017 and then sent for presidential approval in the form of the decree.

Changes to lists of 'tax havens' and 'privileged tax regimes'

On 26 December 2017, the Federal Official Gazette published Normative Instruction RFB 1,773, dated 21 December 2017 (IN 1,773/2017), modifying Normative Instruction RFB 1,037, dated 4 June 2010 (IN 1,037/2010), which in turn lists the countries or dependencies considered as 'tax havens' and 'privileged tax regimes'.

Costa Rica, Madeira, and Singapore have been removed from Brazil's tax haven list. As a result, remittances from Brazil to recipients in those jurisdictions are subject to Brazilian withholding income tax at the rate of 15 percent (and not the 25 percent rate applying to remittances made into tax havens).

However, certain specific regimes within the three jurisdictions are still listed as privileged tax regimes, including:

— Costa Rica's free zones (*zonas francas*).

— Madeira international business centers (*Centro Internacional de Negócios da Madeira — CINM*) in Portugal.

— Several of Singapore's concessionary tax rates of tax.

Transactions with entities subject to privileged tax regimes must observe Brazil's transfer pricing rules — regardless of any corporate relation between the parties. The transfer pricing rules apply in addition to any stricter rules and limits on interest deductibility (thin capitalization).

Adverse tax consequences arise for Brazilian multinationals investing abroad in legal entities subject to privileged tax regimes, including the inability to consolidate results, the inability to have profits of affiliated companies taxed under the cash basis regime, and the inability to deduct up to 9 percent of presumed tax credits.

2013 amendments

A number of changes in the Brazilian tax legislation were put in place as of 2013, directly or indirectly affecting both M&A and cross-border transactions. The main changes that occurred in this period are discussed below.

Goodwill amortization

Historically, corporate tax law defines goodwill as the positive difference between the acquisition price and the net equity of the acquired company.

Tax treatment of the goodwill after pushdown depends on the goodwill characterization as related to:

— fair value of assets (potential tax-deductible step-up)

— future profitability (tax amortization over a minimum 5-year period)

— other economic reasons (non-deductible for tax purposes).

Almost all M&A deals in Brazil involve a share deal with goodwill attributed to future profitability of the target. Aggressive tax planning and its impact on tax collections created significant pressure from the tax authorities to revoke the tax goodwill benefit, especially with respect to intragroup acquisitions. Although not revoked, tax authorities increased rigor in tax audits in order to limit the utilization of goodwill on non-straightforward operations.

As of 2008, IFRS introduced to Brazil's accounting system a new method to compute and register goodwill on the books (purchase price allocation approach — PPA).

No direct tax rules were established to clarify whether this affects the tax impact of the goodwill. Tax practitioners understood that two different interpretations were possible:

— The transitory tax regime provided tax neutrality to any IFRS-related impact, so the recording of goodwill and amortization would remain the same for tax purposes.

— The taxpayer must have a consistent approach to computing and allocating goodwill (for accounting and tax purposes), so PPA potentially would reduce the goodwill to be allocated to future profits.

Provisional Measure 627/13 determines that the goodwill allocation must follow IFRS. Goodwill must be allocated first to the fair value of assets/liabilities and intangibles and the remaining portion is allocated as goodwill (based on future profitability). Tax amortization is preserved, complying with the maximum limit of 1/60 per month. As a condition for the tax deduction of the goodwill, the PPA must be prepared by an independent expert and filed with the Brazilian Federal Revenue or the Register of Deeds and Documents within 13 months.

Goodwill generated as a result of transactions with related parties and involving an exchange of shares is no longer allowed.

The effectiveness of this measure's new regulations is optional for fiscal year 2014 and mandatory for 2015 and later fiscal years (tax-neutrality remains available for taxpayers that decide not to adopt the new regulation in 2014).

As per Law 12,973/2014, goodwill tax deduction is still allowable, providing certain conditions are met, mainly that an independent report is prepared and lodged with the tax authorities and public document register and that the deal is not carried out between related parties.

Payment of dividends and interest on net equity

In Brazil, dividend distributions are tax-exempt for the shareholders. No withholding tax (WHT) and taxation for corporate tax purposes applies.

Interest on net equity (INE) paid is tax-deductible for the Brazilian payer and taxable for the recipient. WHT applies at 18 percent. (Note that this increased taxation was set forth in a provisional measure, a kind of legislation issued by the President, and has not yet been approved by the Congress.) Since INE is calculated based on the value of the net equity, there is uncertainty, similar to that regarding dividends, about whether the value of the net equity should be utilized under IFRS or under Brazilian GAAP.

Methods for testing commodity transactions

Inbound and outbound commodity transactions must be tested using only the following methods:

— The quotation price on imports (PCI) method applies for inbound transactions and is based on the average daily price of goods or rights as recognized on an international futures and commodities exchange, adjusted by the average premium.

— The quotation price on exports (PCEX) method applies for outbound transactions and is based on the average daily price of goods or rights as recognized on an international futures and commodity exchange, adjusted by the average premium.

When the commodity is not recognized on an international futures and commodities exchange, the following sources can be used:

— independent data provided by an internationally recognized industrial research institute (as defined by Brazilian federal tax authority)

— prices published in the official daily gazette by agencies or regulatory bodies for export transactions comparisons.

Normative Instruction 1,312/12 lists the products that must be considered to be a commodity for transfer pricing purposes. It also lists the international futures and commodities exchanges, research institutes and publications that are acceptable sources of market price.

Differential factor margin

The general rule allows a differential factor of 5 percent between the actual price and the comparable price. For commodities transactions, the permitted difference between the actual price and the quotation sourced by international futures and commodities exchanges, research institutes and publications is 3 percent.

Safe harbor

The safe harbor rules for export transactions have been significantly revised. To be eligible for the safe harbor, the net pre-tax profits on exports to a related party must be 10 percent (the prior rule required a 5 percent net profit). However, the safe harbor relief is only available when the export net revenue with related parties does not exceed 20 percent of the total export net revenue during the period.

Interest on related-party loans

Law 12,766/12 introduced new rules for testing the deductibility of interest on related-party loans. These new rules apply to loan agreements as of 1 January 2013, and to the renewal or re-negotiation of existing loan agreements.

The rules on interest and minimal revenue arising from related-party loans include the following:

— For loans denominated in US dollars (US$) at fixed rate, the parameter rate (i.e. maximum or minimum rate, depending on whether the transaction is inbound or outbound) is the market rate of the sovereign bonds issued by the Brazilian government on the external market, indexed in US$.

— For loans in Brazilian real (BRL) at fixed rate, the parameter rate is the market rate of the sovereign bonds issued by the Brazilian government on the external market, indexed in BRL. For loans denominated in BRL at a floating rate, the Ministry of Finance regulates the parameter rate price.

— For all other loans, the parameter rate is the 6-month London Interbank Offered Rate (LIBOR). The spread rate may be determined by Brazil's Ministry of Finance based on market conditions.

In August 2013, the Ministry of Finance fixed the spread margin to be added to the interest rates as follows:

For the purpose of recognition of minimum income:

— 0 percent, from 1 January 2013 to 2 August 2013

— 2.5 percent, from 2 August 2013.

Back-to-back transactions

'Back-to-back transactions' involve the acquisition of goods abroad by a Brazilian company without the goods effectively entering Brazil or being subject to Brazilian customs clearance, followed by resale of the goods to an entity located in a third country. The goods are then shipped directly from the foreign seller to the buyer in the third country, with the transaction being regulated by the Brazilian Central Bank (BACEN).

Previously, it was uncertain whether such back-to-back transactions were subject to Brazil's transfer pricing rules when conducted between related parties, given that there was effectively no entry or exit of the goods into or from Brazil.

Normative Instruction 1,312/12 provides that import and export back-to-back transactions, when performed with related parties and/or with companies located in a 'low-tax jurisdiction' or in a country having a 'privileged tax regime', should be tested separately by applying the import and export methods.

Resale minus (PRL) method

Import tax, customs duties, freight and insurance paid on inbound transactions are not included in the import cost when testing the transaction, provided the payment is made to an unrelated party or to a company or individual not domiciled in a listed low-tax jurisdiction or in a country having a privileged tax regime.

However, when calculating the PRL price, import tax or customs duties, freight and insurance should be proportionally deducted from the net revenue to apply the mark-up established by the law.

Comparable uncontrolled price (PIC) method

Where a Brazilian entity uses its independent transactions as comparables (i.e. a purchase of the same or similar product in the domestic or local market), the third-party comparables must represent at least 5 percent of the amount of import transactions.

Where the minimum sample of independent transactions during the period is not achieved, transactions from the preceding year can be used, provided the foreign exchange effects are appropriately adjusted.

State value added tax — Changes for interstate transactions involving imported goods

According to Resolution 12/2012 issued by the Brazilian Federal Senate, as of January 2013, the applicable state value added tax (ICMS) rate for interstate transactions involving imported goods and products is 4 percent.

Previous legislation established that transactions of this nature involving imported goods and products would be subject to an ICMS rate that varied from 7 to 12 percent, depending on the states of origin and destination.

The regulation applies to interstate transactions involving imported goods and products that are not subject to any industrial process or, when submitted to an industrial process, result in a good or product in which the percentage of utilization of imported inputs is higher than 40 percent of its total cost.

The new interstate rate for imported products does not apply in certain cases or to certain products, such as imported goods and products without equivalent in the Brazilian market, operations of imported natural gas and products subject to certain specific tax incentives.

Tax on financial operations on foreign loans

According to federal Decree 8,325, issued on 7 October 2014, a 0 percent tax on financial operations (IOF) rate applies to foreign loans with weighted average maturity (duration) longer than 180 days. A 6 percent IOF rate remains applicable where maturity is shorter than a 180-day period. As the Brazilian government frequently increases and reduces IOF rates on foreign loans, current applicable IOF rates should be confirmed before implementing an agreement.

Asset purchase or share purchase

Purchase of assets

Brazil's successor liability rules are broad and also apply to asset deals. Brazilian legislation stipulates that private corporations that acquire goodwill or commercial, industrial or professional establishments from an unrelated entity and continue to operate the target business are liable for historical taxes related to the intangibles or establishments acquired. However, where a seller ceases to operate its business, the buyer becomes liable for all the business's historical tax liabilities.

The seller of assets is subject to income tax and social contribution tax (totaling approximately 34 percent) on any increase in value of the assets. For Brazilian tax purposes, no preferential rates apply to capital gains; both operational and non-operational gains are taxed at the same rate, although there is a difference in the tax treatment of capital and ordinary losses.

Purchase price

For tax purposes, it is necessary to apportion the total consideration among the assets acquired. It is generally advisable for the purchase agreement to specify the allocation, which is normally acceptable for tax purposes provided it is commercially justifiable.

Goodwill

Goodwill is recorded as a permanent asset and cannot be amortized for tax purposes, even though it may be amortized for accounting purposes.

Depreciation

The acquisition cost of fixed assets is subject to future depreciation as a deductible expense according to their economic useful life.

Tax attributes

Value added tax (VAT) credits may be transferred where an establishment is acquired as a going concern. Tax losses and other tax attributes remain with the seller.

Value added tax

Programa de Integração Social (PIS) and Contribuição para Financiamento da Seguridade Social (COFINS) may apply, depending on the type of asset sold. These taxes apply on the sale of most assets other than property, plant and equipment (e.g. fixed assets).

Imposto sobre Circulação de Mercadorias e Prestação de Serviços de Transporte Interestadual e Intermunicipal e de Comunicação (ICMS) applies to the transfer of inventory. The tax paid may become a credit to the buyer insofar as these same products are later sold or used as raw materials in the manufacture of products sold by the buyer. The ICMS credits generated on the purchase of the assets generally can be used to offset the ICMS debts arising from later taxable transactions, such as sales. There are restrictions on a taxpayer's ability to use credits on the purchase of fixed assets. Generally, the sale of fixed assets is not subject to ICMS, but ICMS credits generated on the purchase of fixed assets may have to be written off.

Excise tax

Imposto sobre Produtos Industrializados (IPI) also applies to the transfer of the inventory, where the inventory was directly imported or manufactured by the seller. IPI tax paid may also be creditable by the buyer where the product is to be used in the manufacture of other products. IPI may also apply on the sale of fixed assets, where the asset was directly imported or manufactured by the seller and the subsequent sale occurred within 5 years of the date the asset was recorded as a permanent asset by the seller.

Transfer taxes

Municipal real estate transfer tax (ITBI) may apply to the transfer of real estate.

Stamp duties do not apply.

Tax on financial operations

Loans granted to the Brazilian company are also subject to IOF. The rate may vary from 0.38 to 6 percent, depending on the characteristics of the debt (mainly related to the maturity date).

Purchase of shares

The sale or purchase of shares in a Brazilian entity is more common than an asset deal because of lower documentation requirements and indirect taxation.

The taxation of a share sale depends, to some extent, on the residence of the seller and buyer.

A Brazilian corporate seller (*pessoa jurídica*) is subject to income tax and social contribution tax on the net gain from the sale of shares. In most cases, where a seller owns a significant interest (usually more than 10 percent), the gain is calculated as the difference between the gross proceeds and the proportional book value of the target entity's equity.

Whether the seller is a Brazilian individual or a non-resident, the gain is subject to a final 15 percent WHT, but the amount of the gain is calculated differently.

For a Brazilian individual, the gain is calculated based on the difference between the gross proceeds and the capital contributed or paid in a previous acquisition.

For a non-resident, because of the lack of clarity of the relevant tax provisions, there is some debate about how the capital gain is determined. A possible interpretation is that the gain is normally calculated as the difference between the amount of foreign capital registered with the BACEN and the gross sales proceeds in the foreign currency. Another possible interpretation is that the gain should be calculated as the difference in Brazilian currency between the sales proceeds and the capital invested, thereby including exchange fluctuations in the tax base. The tax authorities recently published a normative instruction stating that the gain should be calculated in Brazilian currency. The different positions arise because of differences between the wording of the law and the regulations. It is important to state in the sales contract whether the sale price is gross or net of WHT.

If both the buyer and the seller are non-residents, it is likely that the tax authorities will tax an eventual capital gain. As of 2004, Law 10.833/03 introduced a change to the Brazilian tax law that is interpreted as introducing the taxation of non-residents' capital gains with respect to the assets located in Brazil even when neither party to the agreement is a Brazilian resident. Capital gains on the sale of publicly traded shares are subject to tax at a rate of 20 percent for resident individuals and are exempt for non-residents, provided certain formalities are met and the seller is not a resident of a tax haven.

According to the Brazilian legislation, equity investment funds (FIP) are not legal entities but condominiums with shares held by their investors. Generally, FIPs are exempt from corporate taxes (income and social contribution taxes on profits) and gross revenue taxes (PIS, COFINS), since some requirements are met. Non-resident investors are not subject to Brazilian taxation on the redemption of FIPs' quotas, even where the redemption follows liquidation.

The exemption only applies where certain requirements are met. Among other things, the non-resident must:

— hold less than 40 percent of the FIP's quotas

— not be entitled to more than 40 percent of the income paid by the FIP

— not be resident in low-tax jurisdiction

— not hold the investment in the FIP through an account incorporated in accordance with BACEN rules.

One significant advantage of a share sale over an asset sale is that, where a share sale is structured properly, the amount paid in excess of the net equity of the target may generate an amortizable premium or a step-up in the tax bases of otherwise depreciable or amortizable assets.

This opportunity is not available where shares in a Brazilian company are purchased directly by a non-resident and is not available to the same extent where assets are purchased.

To take advantage of this opportunity, the acquisition of shares needs to be made through a Brazilian acquisition vehicle.

The liquidation or merger of the acquisition vehicle and the target allows the premium paid on the shares to become recoverable in certain situations. To the extent that the premium relates to the value of recoverable fixed assets or the value associated with the future profitability of the company, the premium could be amortized or otherwise recovered through depreciation.

As mentioned earlier, the goodwill allocation must follow IFRS: it must be allocated first to the fair value of assets/liabilities and intangibles and the remaining portion is allocated as goodwill (based on future profitability).

Tax amortization is preserved, complying with the maximum limit of 1/60 per month. The PPA prepared by an independent expert must be filed with the Brazilian Federal Revenue or the Register of Deeds and Documents within 13 months in order to deduct the goodwill for tax purposes.

Tax indemnities and warranties

Generally, tax legislation and prevailing jurisprudence stress that corporate entities resulting from transformations,

upstream or downstream mergers and spin-offs are liable for taxes payable by the original corporate entity up to the date of the transaction. This liability is also applicable on the wind-up of companies whose business continues to be exploited by any remaining partner, under the same or another corporate name, or a proprietorship.

Successor liability depends on one of two factors:

— the acquisition of the business (also referred to in the case law as the acquisition of goodwill, meaning business intangibles)

— the acquisition of the commercial, industrial or professional establishment (i.e. elements that are inherent in and essential for the business).

This rule treats an acquisition of assets that constitutes a business unit similarly to the acquisition of shares of a company where the seller goes out of business. If the seller stays in business with another activity, then the buyer's responsibility is secondary, meaning that the tax authorities must first target the existing seller's assets to satisfy the existing tax contingency.

Regardless of whether the transaction is structured as an asset or share acquisition, due diligence is extremely important in Brazil. The buyer should seek proper indemnities and warranties.

Tax losses

In general, tax losses are kept by the acquired company, but the income tax code provides for some exceptions, including the following:

— On a merger *(incorporação)*, the tax losses of the absorbed company cannot be used by the surviving entity and thus are essentially lost. In a spin-off (cisão), the tax losses of the target entity are lost in proportion to the net equity transferred.

— Carried forward tax losses are forfeited if the company's ownership and main activity change between the tax period in which the losses are generated and the tax period in which they are used.

Income tax regulations provide that tax losses generated in 1 year can be carried forward indefinitely. However, the use of tax loss carry forwards is limited to 30 percent of taxable income generated in a carry forward year.

Further, capital loss carry forwards may only be used against capital gains. The 30 percent limitation applies here as well.

A gain or loss from the sale of inventory generally is treated as ordinary or operational loss, while a gain or loss from the sale of the machinery and equipment, buildings, land and general intangibles is treated as a non-operational (capital) gain or loss.

Pre-sale dividend

In certain circumstances, the seller may prefer to realize part of the value of their investment as income by means of a pre-sale dividend. The rationale here is that the dividend is currently exempt from taxes in Brazil but reduces the proceeds of sale and thus the gain on sale, which may be subject to tax. However, each case must be examined on its merits.

Tax clearances

In Brazil, the concept of tax clearance does not exist. Consequently, tax and labor liabilities are only extinguished on expiration of the statute of limitations. Generally, the statute of limitations period is 5 years, beginning with the first day of the period following the taxable event (normally, a tax period comprises a month or a year).

Choice of acquisition vehicle

Several potential acquisition vehicles are available to a foreign buyer, and tax factors often influence the choice.

Local holding company

A Brazilian holding company is typically used where the buyer wishes to ensure the tax-deductibility of the goodwill paid or where tax relief for interest is available to offset the target's taxable profits.

Foreign parent company

The foreign buyer may choose to make the acquisition itself. This does not necessarily cause any tax problems in Brazil, as dividends are currently exempt from WHT. However, Brazil does charge WHT on interest.

Non-resident intermediate holding company

As mentioned earlier, a direct sale of a Brazilian company's shares by a non-resident is subject to WHT in Brazil where a capital gain is recorded. Until 31 December 2016, the WHT rate was 15 percent. As of 1 January 2017, progressive rates apply as follows:

— 15 percent on the portion of gain up to BRL5 million

— 17.5 percent on the portion of gain between BRL5 million and BRL10 million

— 20 percent on the portion of gain between BRL10 million and BRL30 million

— 22.5 percent on the portion of gain exceeding BRL30 million.

An intermediate holding company resident abroad could be used to defer this tax. However, both buyer and buyer should be aware that the Brazilian tax authorities may try to establish whether this intermediate company has a real economic purpose and substance in order to look through the intermediate company and charge the appropriate tax.

Local branch

A Brazilian branch of a multinational company is treated as a regular legal entity in Brazil for tax purposes. A branch is also subject to Brazilian law and courts with regard to business and transactions it carries out in Brazil.

Generally, a business unit (branch) of a foreign company located in Brazil requires prior approval from the federal government by presidential decree, which is a lengthy process. The federal government also must authorize any amendments to the branch's articles of incorporation.

The power to grant the authorizations may be delegated. Currently, the authorizations must be issued by the Ministry of Development, Industry and Commerce.

Joint venture

Joint ventures are corporate companies (with the joint venture partners holding shares in a Brazilian company). There are no special rules for the taxation of such entities.

Choice of acquisition funding

From a Brazilian tax perspective, the capitalization of an entity with debt or equity is influenced by the expected profitability of the company. At least for a non-resident shareholder, financing through debt is generally more tax advantageous as interest paid on the debt is fully deductible for Brazilian corporate tax purposes. The potential benefits of an interest deduction may outweigh the WHT burden associated with the interest paid.

Foreign capital must be registered with the BACEN (Law 4131/62). Obtaining the foreign capital registration is of paramount importance because this is the foundation for paying dividends and repatriating capital in foreign currency, and, in some cases, it is required to record a tax base in a target company's shares or assets.

Deductibility of interest

Changes to Brazilian legislation were published on 16 December 2009. Among them, KPMG in Brazil highlights the first legal provision in Brazil on thin capitalization. The legislation establishes new requirements for the deductibility of interest expenses arising from debt operations. Generally, for tax purposes, the debt cannot be higher than:

— two times the amount of the participation of the lender located anywhere outside Brazil (except for lenders located on low-tax jurisdictions or under a privileged tax regime) in the net equity of the borrower

— 30 percent of the net equity of the borrower where the lender is located in a low-tax jurisdiction or under a privileged tax regime (whether a related party or not).

This rule also applies for any kind of debt operation where a foreign related party acts as guarantor, co-signer or intervening party of the debt contract.

This legislation also defines specific requirements that taxpayers must meet to deduct payments to beneficiaries located in a low-tax jurisdiction or under a privileged tax regime. These requirements include identifying the beneficiary owner and determining the operational capability of the foreign party to carry out the operation agreed with the Brazilian party.

Withholding tax on debt and methods to reduce or eliminate it

There is a WHT burden of 15 percent associated with the interest paid (25 percent if paid to a tax haven resident).

Equity

Unlike interest, dividends are not subject to WHT when paid to a non-resident.

Additionally, Brazilian tax law (Law 9.249/95) allows a company to elect to pay interest to shareholders as return on equity capital at the official long-term interest rate.

Interest on equity paid or accrued to resident or non-resident shareholders is generally deductible for income tax and social contribution tax purposes. The payment is subject to WHT of 18 percent, as previously noted. However, opinions are divided on whether an increased rate should apply where the recipient is a tax haven resident. Brazilian tax authorities believe that a WHT of 25 percent should apply in such cases.

INE is calculated by applying the daily pro rata variation of the long-term interest rate (TJLP) or 5 percent (whichever is lower) to the value of the company's net equity accounts at the beginning of the year. Increases and decreases in the equity accounts must also be considered in the computation, and the deduction is subject to limitations.

Because of its unique nature, interest on equity payments may be considered as dividend payments in several recipients' home countries, carrying underlying foreign tax credits or being exempt, while being deductible for Brazilian income tax and social contribution tax purposes.

Corporate reorganization

Generally, corporate reorganizations (e.g. *incorporações, fusões* and *cisões*), liquidations and capital contributions — including capital contributions of shares — can be accomplished tax-free in Brazil, as long as assets are transferred at tax book value and other formalities are met.

However, there may be reasons to structure a reorganization as a taxable transaction (e.g. transfer of assets at fair market value). For example, transferring assets as part of a reorganization may allow:

— use of current-year losses that would otherwise become subject to loss limitations

— international tax planning

— a step-up in the tax bases of assets.

Hybrid instruments (i.e. instruments that may have either debt and equity characteristics or that may be treated differently in different jurisdictions) are relatively new to Brazil. They are being used with limited success. Brazil has very flexible tax rules with respect to debt, which makes the creation of hybrid financing instruments possible, but strict exchange control regulations generally limit the taxpayer's options.

Other considerations

Company law and accounting

Brazilian GAAP is mainly governed by corporate law (Law 6.404/76) and the basic conceptual framework is provided by the Conselho Federal de Contabilidade (CFC — Accounting Federal Council).

On 28 December 2007, Law 6.404/76 was amended and modified in certain aspects by Law 11.638/07, which is effective from 1 January 2008. One of the main objectives of Law 11.638/07 is to align Brazilian GAAP with IFRS.

The rules and regulations issued by Brazil's federal securities regulator (CVM) are consistent with international accounting standards adopted in the major financial and capital markets. The implication is that a systematization of new financial reporting standards, applicable to the preparation of financial statements and financial reports in general, gradually will converge to full adoption of IFRS. This convergence, currently in progress, is being coordinated by the Accounting Standards Committee (CPC).

Generally, Brazilian GAAP is based on the accrual method of accounting, unless specific legislation or a rule states otherwise. Inflationary adjustments are not required in financial statements.

Group relief/consolidation

Brazil does not have group relief or tax consolidation rules.

Transfer pricing

In structuring acquisitions and reorganizations, it is important to keep in mind the potential application of Brazil's tax rules related to transfer pricing and disguised distributions of profits. Generally, these provisions require that Brazilian-resident companies that buy or sell assets, including shares, from or to a related party do so at market value determined according to specific rules. Variations from market value may increase tax or reduce the tax base.

Foreign investments of a local target company

Brazilian controlled foreign company rules (CFC) subject any profits recorded by foreign subsidiaries to tax in Brazil at the end of the year. A foreign tax credit is granted up to the amount of Brazilian tax due on the same profits.

Losses generated by the foreign subsidiary can be offset against future profits generated abroad but not against Brazilian profits.

Comparison of asset and share purchases

Advantages of asset purchases

— Buyer usually obtains a step-up in the bases of the assets.

— Where the assets acquired constitute a going concern (*acervo de negócios*), the buyer may obtain benefits of tax credits and certain other tax attributes, especially those associated with indirect taxes, such as IPI and ICMS.

— Often helps minimize the inheritance of tax, legal and labor liabilities.

— May take less time to implement.

Disadvantages of asset purchases

— Tends to result in a more tax burdensome transaction when compared to a share deal (especially for IPI, ICMS, PIS, COFINS and ITBI purposes).

— May prevent the buyer from acquiring the target's tax losses and other tax attributes.

— From a seller's perspective, an asset sale may provide much more limited opportunities than a share sale for tax planning to minimize gains on the assets sold.

— Where the assets transferred constitute a going concern (*acervo de negócios*), some inheritance of liabilities cannot be avoided. The buyer of a going concern generally remains with joint, several or secondary liability for pre-acquisition tax liabilities related to the business acquired, depending on whether the seller continues to operate in the same line of business.

— Depending on the assets or business acquired, acquiring assets may require new registrations for tax, labor and other regulatory purposes, termination costs, re-hiring costs for employees and other administrative burdens. Brazilian labor and tax laws provide for significant termination costs for employers. In an asset sale, employment technically must be terminated, triggering certain severance costs that can be significant.

— The post-acquisition administrative burden associated with the transfer of the assets or a going concern can be much more significant in an asset sale.

Advantages of share purchases

— Minimization of tax impacts, especially for IPI, ICMS, PIS, COFINS and ITBI purposes.

— Where the transaction is structured properly, the buyer may be able to obtain a better tax result by structuring the acquisition as an acquisition of shares rather than acquiring the assets directly. The benefit is that acquiring shares allows for the recovery of the purchase premium (sales proceeds exceeding book value of the target company) through amortization. The nature of the premium is significant for Brazilian tax purposes, but in

most cases, a premium can be recovered over a 5-year period — significantly faster than the recovery period for most fixed assets, which are generally depreciable over 10 years.

— Tax losses and other tax attributes of the target company may be carried over (see 'Tax losses').

— Where employees are to be transferred with the target business, it may be possible to transfer them with the acquired business without terminating their employment.

Disadvantages of share purchases

— Pre-acquisition tax liabilities of the target remain with the purchased legal entity.

— Where the buyer wants to purchase only part of the target's business, pre-acquisition structuring steps may take some time to implement.

KPMG in Brazil

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Colombia

Introduction

Cross-border merger and acquisition (M&A) activity in Colombia has been increasing in recent years, as the government has been reforming the tax system to enhance tax benefits for foreign investors.

This report analyzes the main tax issues that potential foreign investors should consider when deciding to invest in Colombia.

Recent developments

In December 2012, the national government enacted a tax reform introducing important structural changes to the tax system and regulating cross-border transactions.

The tax reform incorporated anti-abuse, thin capitalization, permanent establishment (PE) and place of effective management rules. New comparability criteria for transfer pricing regulations were established, a list of tax havens was issued, the tax effects of M&As were specifically regulated, and control mechanisms for international transactions were enacted.

In December 2016, the national government enacted another tax reform bill. Changes include:

— modifying the current rates of income tax and withholding tax (WHT) and establishing a new surcharge

— repealing the income tax for fairness (CREE by its Spanish acronym)

— establishing new transfer pricing reports (i.e. local file, master file and country-by-country (CbyC) report

— regulating controlled foreign corporations (CFC)

— establishing new rules for non-cooperative jurisdictions, low-or zero-tax jurisdictions and preferential tax regimes, and modifying the applicable income tax and exemptions

— incorporating a definition of the 'beneficial owner' in the tax law.

The corporate income tax rate was increased to 33 percent (for fiscal (FY) 2018 and later years), plus a surcharge of 4 percent on net income of 800,000,000 Colombian pesos (COP; about 280,000 US dollars — US$) or more. The surcharge only applies for FY2018.

As a result, effective income tax rates are:

— for national companies and non-resident entities:

  — FY2018: 37 percent (33 percent income tax, plus 4 percent income surtax)

  — FY2019 and later: 33 percent.

— for non-resident individuals: 35 percent

Colombia has implemented International Financial Reporting Standards (IFRS). Income tax is generally determined based on IFRS, with some exemptions.

Colombia has begun developing a network of tax treaties that generally follow the principles of the Organisation for Economic Co-operation and Development (OECD). Treaties with Chile, Mexico, Canada, Spain, Switzerland, Portugal, Czech Republic, Korea and India have been signed and are currently in force. Treaties with France, United Kingdom and Italy have been signed and are in the internal process of approval. Treaties with the Netherlands, Japan and the United States are being negotiated. The Colombian government has immediate plans to negotiate treaties with another 15 countries. Colombia also participated in the process of signing of the Multilateral Instrument (MLI). The MLI will align Colombia's current treaty network with the OECD's standards for addressing base erosion and profit shifting (BEPS) once the MLI is brought into force and the Colombian legislative and constitutional approval procedures are complete.

The special free trade zone regime continues, granting users classified as 'industrial users of goods and services' a reduced income tax rate of 20 percent (up from 15 percent as a result of the 2016 tax reform).

A deduction is available for investments in science and technology of 100 percent of the invested value as well as a discount of 25 percent of the same value, subject to pre-qualification by the national government.

Asset purchase or share purchase

A foreign investor may acquire a Colombian company by purchasing either its shares or its business assets. Usually, acquisitions are carried out by purchasing shares in a Colombian entity because this creates no direct tax liability for the foreign investor. Dividends from profits taxed at the level of the distributing entity (PTP) are subject to a 5 percent income tax withholding on the gross payment or accrual of the dividend, which differs from the 38.25 percent income tax withholding on dividends from profits not taxed at the level of the distributing entity (non-PTP).

Whether shares or business assets are sold, their subsequent sale produces a taxable capital gain taxed at a rate of 37 percent for 2018 (33 percent income tax rate plus 4 percent income surcharge rate if applicable) and 33 percent for 2019 and later years, or at 10 percent, depending on the length of time that the shares or business assets were owned.

Purchase of assets

In a purchase of business assets, real estate tax (land/property tax) liabilities remain attached to the acquired assets, so the purchaser could be liable for such tax.

Profits from the use of the acquired assets are subject to income tax. Since PE rules have been introduced, owning assets in Colombia under certain circumstances could come with an obligation to register with the tax authorities and keep tax accounts.

Profits derived from the sale of assets could produce a taxable capital gain. The sale of inventories could be subject to value added tax (VAT) and other taxes.

Purchase price on assets

The purchase price is the price agreed by the parties, provided it does not diverge by more than the 25 percent from the fair market price of goods of the same kind at the date of the sale. The sale price of real estate cannot be lower than its fiscal cost, the valuation recorded in the land registry office, or the price recorded in the previous year's real estate tax return. Transactions carried out between Colombian taxpayers and foreign related parties are subject to transfer pricing rules.

Purchase price of shares

For shares of entities that are not listed on a stock exchange, unless there is evidence justifying a different value, the selling price of the shares cannot be lower than their intrinsic value (entity's accounting net equity/outstanding shares) plus 15 percent.

In addition to transfer pricing liabilities, if the buyer is an affiliate, the sale price is determined using commonly accepted financial valuation methods, particularly those that allow identifying fair market value (FMV) through the present value of future income. In no case would use of the book value (known as 'intrinsic value' in Colombia) of the shares be considered as a valid valuation method.

Goodwill

With the tax reform of 2016, goodwill paid on the acquisition of assets or commercial establishments is generally not amortizable. Some exceptions may apply.

On share acquisitions, the tax reform of 2016 stated that no intangible assets are triggered. Goodwill is understood to be the difference between the acquisition price and the book value of the shares. Valuations of the business and the intangible assets may be required.

Depreciation

The tax authorities recognize and accept depreciation of a company's fixed assets used during the tax year. Useful life terms are established by law and are mandatory. The rates of depreciation range from 2.22 percent to 33 percent, depending on the asset. Taxpayers can use the depreciation methods established in the accounting rules.

Value added tax

VAT is levied at the rate of 19 percent on the sale of tangible movable goods located in Colombia at the time of the sale, services rendered within the Colombian territory, and importations of tangible movable goods. Sales of fixed assets and/or shares are excluded from VAT.

Transfer taxes

Real estate tax (land tax) is a municipal (local) tax levied on real estate in the municipality at rates ranging from 0.10 to 0.33 percent of the real estate's value.

A registry tax is levied on the registration of the documents transferring the ownership of real estate with the property registration office. In this case, the tax is 1 percent of the price of the real estate included in the registered public deed.

Purchase of shares

Investing in a Colombian company by purchasing its shares does not lead to a direct tax liability for the investor. Dividends from profits taxed at the level of the distributing entity (PTP) are subject to a 5 percent income tax withholding on the gross payment or accrual of the dividend, which differs from the 38.25 percent income tax withholding on dividends from profits not taxed at the level of the distributing entity (non-PTP).

These rules apply unless the dividends are paid to a resident of a country that has an enforceable tax treaty with Colombia. In such cases, the tax rate is as stipulated in the treaty.

Where the tax profit available to be distributed without WHT (i.e. profits that have been taxed at the distributing company´s level) exceeds the amount of accounting profits for the year, the excess can be carried back for 2 years and carried forward for 5 years.

By contrast, the sale of a Colombian company's shares to residents or non-residents generates a tax liability in Colombia for the seller. The taxable income is the positive difference between the sale price and the tax cost of the shares. The sale price must be determined using accepted technical valuation methods.

The tax cost corresponds to the acquisition cost, plus tax adjustments. Transactions between related parties are subject to transfer pricing rules.

Tax indemnities and warranties

In a share acquisition, the purchaser takes over the target company, including all related liabilities, so the purchaser usually requires more warranties and indemnities than in the case of a business assets acquisition. Where significant sums are at stake, it is common for the purchaser to carry out a due diligence exercise, including a review of the target's tax issues.

Tax losses

General tax losses are treated as follows:

— For mergers, losses can be used where the merging companies share the same economic activity before the merger.

— For mergers, losses originating in each merging company can be used only to offset the taxable income of the merged company at the same percentage as the absorbed company's net equity represents to the absorbing company's equity.

— The tax reform of 2016 provides that the losses accrued as of FY2017 can be offset against the net income in the 12 FYs following the taxable year in which loss arose.

— Losses incurred in FY2006 and earlier have 8-year and 25 percent limitations, and losses related to non-taxable income and non-deductible expenses cannot be offset.

Transfer taxes

The national stamp tax rate is 0 percent. Local jurisdictions (municipalities) are entitled to levy their own stamp duties.

Choice of acquisition vehicle

Several acquisition vehicles are available to a foreign investor purchasing a Colombian company, and the tax effects for each vehicle differ.

Local holding company

Acquisitions can be structured through Colombian holding companies.

Foreign parent company

A foreign parent company can be used as an acquisition vehicle to push debt down to the Colombian target. However, Colombia's new thin capitalization rule requires a 3:1 debt-to-equity ratio. Interest paid in excess of the ratio is not tax-deductible. In any case, the new anti-abuse rule needs to be analyzed before implementing this alternative.

The transactions also must comply with transfer pricing regulations. Where the transaction is not within the applicable ranges, the interest is re-categorized as dividends.

Non-resident intermediate holding company

Where the foreign country taxes capital gains and dividends received overseas, an intermediate holding company resident in another country could be used to defer such taxes. The intermediate holding company can be incorporated in a country with an enforceable tax treaty with Colombia, although the treaty's limitation on benefits (LOB) and/or anti-abuse clauses of the relevant treaty would have to be analyzed.

Local branch

The foreign investor could purchase the business assets of a Colombian company through a branch incorporated in Colombia. However, branches are Colombian taxpayers and subject to income tax, VAT, financial transactions tax, customs duties and all local (municipal) taxes, such as industry and commerce tax and municipal stamp duties. Branches are liable for all formal obligations related to these taxes and required to file periodic tax returns.

Under rules of tax reform of 2012, where branches or PEs transfer their profits abroad, the transfer is considered to a dividend that could be subject to WHT, as discussed earlier.

Branches are subject to income tax at rates of 37 percent for 2018 (33 percent for income tax and 4 percent for income tax surcharge if applicable), 33 percent for 2019 and later years, but only on their national (Colombian) income and their national net worth. Colombian regulations do not allow branches to acquire shares of Colombian companies.

Joint venture

Certain activities can be carried out through joint ventures. However, since joint ventures are not considered legal entities separate from their members, each member is liable for tax on profits earned from the activities performed directly by the joint venture.

Choice of acquisition funding

A foreign investor can use a Colombian acquisition vehicle and finance it with capital contributions, debt or a combination of both.

Debt

The main advantage of debt is the potential tax deduction of installments, interest and related expenses, such as guarantee fees, bank fees, financial costs and exchange rate differences. Bear in mind that Colombia's thin capitalization rules could limit the deductibility of interest.

Foreign loans to Colombian companies are subject to income tax withholdings. Loans regardless the term are subject to a 15 percent withholding. Where the lender is a related party, the transaction is subject to several transfer pricing rules.

Deductibility of interest

Interest payments are deductible, provided the loan was used in income-producing activities and WHT was applied to the payments. Interest payments should be deducted in the same fiscal year in which they are made. Financial costs and expenses related to the debt are also deductible, provided they are related to the income-producing activity.

Under the thin capitalization rule, interest paid on debts is only deductible where the average total amount does not exceed 3 times the taxpayer´s previous year's net equity (i.e. 3:1 ratio). For this purpose, only interest-generating debts are considered.

The thin capitalization rule applies to debts with local or foreign entities, whether they are related or non-related parties. Transactions with foreign related parties should be reviewed to determine the impact of the transfer pricing rules.

Loans between affiliates must meet several comparability conditions.

Withholding tax on debt and methods to reduce or eliminate it

Interest paid on debt is subject to income WHT at the rate of 15 percent. Reduced rates apply to interest on foreign loans with entities located in countries with enforceable tax treaties (0, 5, 10 and 15 percent). See the table of WHT rates under Colombia's tax treaties at the end of this report.

Checklist for debt funding

- Bear in mind the thin capitalization rule.
- For indebtedness with foreign lender, inform the Colombian Central Bank before disbursement of the loan.
- Where the lender is a related party, transfer pricing rules apply.
- Interest payments, financial costs and expenses are deductible, subject to certain requirements.

Equity

Foreign investors can fund the Colombian vehicle through direct contributions to the capital of the vehicle. Profits transferred from the vehicle to the investor are subject to WHT at the same rates applicable to dividends. Where such profits are paid to a resident of a country with an enforceable tax treaty, the WHT rate may be reduced.

Discounted securities

The investment could be channeled through the acquisition of certain discounted securities, such as the 'BOCEAS', the Spanish acronym for bonds that convert into shares at a certain price or at a discount once the bonds reach maturity or a predetermined time has elapsed.

Other considerations

Concerns of the seller

A sale of shares or business assets to residents or non-residents generates a tax liability in Colombia for the seller. The taxable income is the excess of sale price over the tax cost of the shares or business assets.

For non-listed shares, the sales price agreed by affiliates is determined based on acceptable technical studies.

The tax cost of shares is the acquisition cost plus tax adjustments. The tax cost of business assets is the historical cost less the relevant depreciation.

A Colombian taxpayer should include in the income tax return as a capital gain the profits derived from the sale of shares or business assets owned for 2 years or more, which are taxed at 10 percent.

Where the shares were owned for less than 2 years, capital gains should be included in the return as ordinary income, which is taxed at a rate of 37 percent for 2018 (33 percent income tax plus 4 percent income surtax if applicable) and 33 percent for 2019 and later years.

Foreign investors must file an income tax return within 1 month of a sale of shares. Transfer pricing requirements may apply.

A transfer of shares that result from a merger or a spin-off transaction between foreign companies could trigger a taxable event where the value of the assets located in Colombia represents more than 20 percent of the total assets owned by the group to which the entities involved in the merger or spin-off belong.

Finally, keep in mind that under new anti-abuse rules, and according to the specific facts and circumstances, the taxpayer could be required to prove that the merger or spin-off has a business purpose (rather than only the purpose of obtaining any tax benefits).

Company law and accounting

Transfer pricing rules apply to transactions with foreign related parties and with free trade zones.

The commercial code governs how companies may be incorporated, operated, reorganized and dissolved. The principal types of companies are described below.

Corporation (*Sociedad Anónima — SA*)

A corporation must have a minimum of five shareholders. Each shareholder is liable up to the amount of its capital contribution as represented by negotiable shares. The corporation's capital is divided into authorized share capital, subscribed share capital and paid-up share capital. At the time of the company's incorporation, at least 50 percent of its authorized share capital must be subscribed and at least 33 percent of its subscribed share capital must be paid-up. The balance must be paid during the year following the incorporation of the company.

Some characteristics of these corporations are as follows:

— Where a corporation needs to be capitalized, it may issue shares or bonds that are convertible into shares.

— Shares may be sold at any time without restriction, unless the bylaws provide for a special procedure or a pre-emptive right in favor of existing shareholders or the company. Where a corporation's shares are registered on the stock market, they may be freely negotiated.

— The shareholders can meet to deliberate and reach decisions in a place other than the corporation's main offices, and even abroad, if the total of the corporation's shares is represented at the meeting.

— The corporation is dissolved when 95 percent or more of the contributed shares belong to one shareholder.

Limited liability company (Ltda)

A limited liability company may be organized with a minimum of two partners and a maximum of 25. The partners are liable up to the amount of their capital contributions, except for tax and labor liabilities, in which case partners can be severally and jointly liable along with the company in accordance with particular provisions. The capital of the company must be fully paid at the time of the incorporation and is divided into capital quotas of equal amounts, which may be assigned in accordance with the provisions in the company's by-laws and Colombian law.

The limited liability company's highest direction and administration body is the board of partners, in which the partners have as many votes as they own capital quotas in the company.

The capital quotas of limited liability companies may be assigned to other partners or third parties, after approval by the board of partners. Every capital quota assignment implies an amendment of the articles of incorporation that must be legalized by a public deed and registered with the Chamber of Commerce of the company's registered place of domicile.

A statutory auditor is mandatory if stipulated by the articles of incorporation or when the assets are higher than 5,000 minimum legal wages (US$1,240,000 approximately) or the revenues are higher than 3,000 minimum legal wages (about US$754,000).

Limited partnership (*Sociedad en Comandita Simple y en Comandita por Acciones*)

A limited partnership involves one or more managing partners who commit themselves to a joint and unlimited liability for the entity's transactions (partners with unlimited liability) and one or more non-managing partner(s) whose liabilities are limited to their respective capital contributions (limited liability partners).

The partnership equity consists of the capital partner's contributions and those of the managing partners or partners with unlimited liability.

Limited partnership entities can be subdivided into simple limited partnerships and shares partnerships. A simple limited partnership's equity is divided into partnership quotas, while a shares partnership equity is divided into shares. Therefore, limited partnerships involve elements of both capital-based entities and person-based entities.

On incorporation and for statutory modifications, limited partnerships follow the general requirements for a public deed and notary expenses.

Partnership (*Sociedad Colectiva*)

Partnerships are the least commonly used corporate type in Colombia, given their inflexibility regarding incorporation and modifications and the comprehensive responsibility of its partners for the obligations entered into by the partnership. The equity is divided into 'parts of interest' that confer one vote to each partner regardless of the partner's contributions to the partnership's capital.

The partnership is fully represented by all its partners, which are also in charge of its management in every way.

Simplified joint-stock corporation (*Sociedad por Acciones Simplificada — SAS*)

The SAS can be incorporated in Colombia with a single shareholder. In every case, the incorporation of a SAS gives rise to a new legal entity completely independent of its shareholders or shareholder.

The liability of the shareholders of the SAS is limited to the amount of the subscribed capital; the shareholders of a SAS are never jointly and severally liable for tax or labor liabilities.[1] Being the most flexible and 'customizable' corporate type in Colombia, it is possible to create different kinds of shares for the SAS, such as shares with fixed dividend that grant the right to receive a fixed dividend, not withstanding the percentage of participation of the shareholder.

A financial or statutory auditor is mandatory if stipulated by the articles of incorporation or when the assets are higher than 5,000 minimum legal wages (about US$1,240,000) or the revenues are higher than 3,000 minimum legal wages (about US$754,000).

The structure of the SAS is simple because:

— it does not need a board of directors, unless otherwise required by its articles of incorporation (bylaws)

— all management and representative activities can be carried out by the legal representative appointed by the shareholders' meeting (which could be constituted by single or multiple shareholders)

— the shareholders' meeting can directly implement decisions (e.g. approving financial statements, dividend distributions, corporate accounts; the shareholders assembly may also assign these activities to a board of directors or legal representative

— the SAS may be incorporated by means of a private document, making it simpler and more cost-efficient to create than entities requiring a public deed and notary expenses.

In addition, the SAS may choose to have as its corporate purpose 'any lawful activity'[2] and may have an undetermined duration.

At the time of incorporation, the subscribed capital may be of any amount desired by the shareholders and no proportion of other capital is taken into account.[3] The subscribed capital may be paid in proportions and on deadlines agreed in the articles of incorporation not exceeding 2 years.

Merger

Under Colombian law, a merger of companies is a complex legal transaction by which one or several companies are dissolved but not liquidated and absorbed by another company or combined to create a new company. The merger is achieved by means of an equity transfer representing all the assets and liabilities of the absorbed companies into another absorbing company, which may be newly formed or pre-existing.

In this situation, the absorbing or new company acquires the rights and obligations of the dissolved companies as they were at the time of the execution of the merger agreement.

Tax effect of company merger

The tax reform of 2012 established two kinds of mergers: acquisitive mergers and reorganizational mergers. Acquisitive mergers take place where the merging entities are not related parties, while reorganizational mergers take place where the merging entities are related. In both cases, the merger is tax-neutral, provided certain requirements are met.

For both types of mergers, the shareholders of the merging entities must meet several requirements related to the percentage of participation. For example, for acquisitive mergers, at least 75 percent of the shareholders of the merging entities must have a participation in the resulting entity equivalent in substance to the participation previously owned in the merging entities (although in proportion to the resulting entity).

In both cases, tax penalties apply where the shareholders alienate or assign their shares or economic rights before the end of the second taxable year end (counted from the transaction's completion).

Tax regulations stipulate that the absorbing or new company is responsible for paying the taxes, advances, withholdings, penalties, interests and other tax obligations existing in the merged or absorbed companies.

Demerger or spin-off of companies

In accordance with applicable commercial regulations (law 222, dated 20 December 1995), a spin-off can be carried out in two ways:

— A company, without being dissolved, transfers in a block one or several portions of its net worth or patrimony to one or more existing companies or uses such portion(s) to set up one or more new companies.

— A company is dissolved but not liquidated and splits its net worth or patrimony into two or more portions that are either transferred to several existing companies or used to create new companies.

[1] However, the corporate veil may be pierced if the company is used for fraud against third parties.
[2] However, simplified corporations cannot negotiate its shares in the stock market or be used to develop activities that are under the supervision of the Superintendence of Finances (e.g. banking and insurance activities).
[3] See, for example, the proportions required in corporations.

Tax effect of demerger or spin-off

The tax reform of 2012 established two kinds of spin-offs: acquisitive spin-offs and reorganizational spin-offs. Acquisitive spin-offs occur where the spun-off entity and the beneficiary entities (if any) are not related parties. Reorganizational spin-offs occur where the spun-off entity and the beneficiary entities (if any) are not related. Both types are considered tax-neutral transactions, provided certain requirements are met.

The requirements for spin-off entities and shareholders follow the same rules that apply for mergers.

Under the new regulations, for a spin-off to be tax-neutral, special requirements must be met regarding the assets to be transferred.

Transfer pricing

Transfer pricing rules apply to taxpayers engaged in transactions with foreign related parties. All transactions with foreign related parties must be reported in the relevant return, and supporting documentation must be prepared and kept available at any time for the tax authorities. The OECD's transfer pricing principles are followed as guidelines for transfer pricing purposes in Colombia.

The tax reform of 2012 introduced new comparability criteria for transactions with related parties, subjected new transactions to the transfer pricing rules, and established new methods for determining profit margins for transactions with related parties. The tax reform of 2016 established new reports for transfer pricing documentation (local file, master file and CbyC report).

Foreign investments of a local target company

Colombian entities can invest in foreign companies, but they must register such investments with the Central Bank. Taxes paid abroad can be credited against the Colombian liability (Colombian taxpayers pay their income tax on worldwide profits).

Comparison of asset and share purchases

Advantages of asset purchases

— The price paid to acquire a fixed asset, adjusted for inflation up to 31 December 2006, can be used as the basis for depreciation or tax amortization.

— When used goods are acquired, the assets can be depreciated over the remainder of their useful life, after deducting the depreciation period used by the seller.

— An asset purchaser does not take on any risk or contingency relating to the commercial or tax obligations of the selling company, unless the asset acquired carries a mortgage or pledge or in the case of real estate where the real estate tax (land tax) liability is transferred.

— Possible to acquire only part of a business.

Disadvantages of asset purchases

— A permanent establishment could arise. The facts and circumstances should be analyzed to identify any potential risk.

— Possible need to renegotiate supply, employment and technology agreements and to renew licenses.

— Sale generally requires access to greater cash resources.

— Benefit of losses incurred by the target company remains with the seller.

— Depending of the type of agreement, a public deed to formalize the deal could be required to be executed and registered, generating a notary fee (approximately 0.3 percent) plus a registration tax of 1 percent of the total price stated in the document.

Advantages of share purchases

— Sale generally requires less capital outlay.

— Purchaser may benefit from existing supply and technology agreements.

— A share sale does not require registration duties, but the transaction must be reported to the Central Bank.

— Target keeps its losses and tax attributes, which can be offset in the future against taxable income.

— An anti-abuse rule introduced in 2012 and strengthened in 2016 that penalizes taxpayer behaviors aimed at evading taxes might be applicable. Based on the 'substance over form' principle, the rule states that, for tax purposes, transactions that do not have a real business purpose other than obtaining a tax benefit are not accepted.

— Transactions with parties in jurisdictions on the government's tax haven list may be restricted in terms of income tax deductibility and attract higher WHT.

Disadvantages of share purchases

— Purchaser acquires liability for the commercial obligations of the company up to an amount equal to their capital contribution (limitation applicable to SAS and SA).

— The partners of limited liability companies (Ltda) are severally and jointly liable for tax debts.

— Partners are also jointly liable for some labor liabilities of the partnership.

Colombia — Withholding tax rates

This table sets out reduced WHT rates that may be available for various types of payments to non-residents under Colombia's tax treaties. This table is based on information available up to 1 January 2016.

Source: Colombia's double taxation conventions, 2016

	Dividends	Interest[1] (percent)	Royalties (percent)
	Companies (percent)		
Domestic rates	5/38.25	15	15/26.4[2]
Companies:	5/38.25	15	15/26.4[2]
Individuals:			
Treaty rates			
Treaty with:			
Bolivia[3]	—[4]	—	—
Canada	5/15[5]	10	10
Chile	0/7/35[6]	5/15[7]	10
Ecuador[8]	—	—	—
Peru[8]	—	—	—
Spain	0/5/35[6]	10	10
Switzerland	0/15[6]	10	10
Mexico	0/33	5/10[9]	10
Portugal	5/33[6]	10	10
Czech Republic	5/25[6]	10	10
South Korea	5/15[6]	10	10
France	5/15[6]	10	10
UK	0/5/15[10]	10	10

Notes:

1 Many treaties provide for an exemption for certain types of interest, e.g. interest paid to government institutions or to state-owned institutions (including governmental financial institutions). Such exemptions are not considered in this column.

2 The 26.4 percent rate applies on software royalties.

3 Based on Decision 578 of the Andean Community, Colombia would have the right to tax dividends and interests paid by Colombian residents.

4 The domestic rate applies; there is no reduction under the treaty. The source state has the exclusive right to tax.

5 In some tax treaties, the rates would depend on the shareholder´s participation in the distributing entity and could vary due to the application of the domestic law.

6 See note 5.

7 The 15 percent in general, reduced to 5 percent for interest derived by banks or insurance companies.

8 See note 3.

9 The 10 percent in general; reduced to 5 percent for interest derived by banks or insurance companies.

10 See note 5. The 0 percent rate applies if the beneficial owner is a pension fund.

KPMG in Colombia

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Costa Rica

Introduction

Despite the current international economic environment, Costa Rica remains attractive to foreign investors for a number of reasons, including economic and political stability. Unlike other Latin American countries, Costa Rica has not changed its tax legislation significantly in recent years. Major tax reforms have been discussed for several years, but proposed modifications have not been enacted. However, at the time of writing this report a fast-track procedure has been approved in Congress for the approval of amendments to the Corporate Income Tax and for changing the Sales Tax into a VAT. The considerations below basically consider the current legislation and therefore is advisable to confirm if any variation applies to M&A transactions.

Costa Rican tax legislation includes little regulation of merger and acquisition (M&A) transactions. The most important regulation, particularly for mergers, is incorporated in Costa Rican commercial law.

Despite this lack of regulation, M&A activity may be subject to scrutiny by tax authorities to determine if taxpayers derived undue benefits, mainly related to deductible expenses.

Since capital gains are not taxed in Costa Rica, they are excluded from gross taxable income unless:

— The gain is related to a habitual activity.

— Tangible assets subject to depreciation are transferred.

The Costa Rican Commerce Code sets out in articles 220–224 the effects of and necessary procedure for merging two or more Costa Rican entities as follows:

— The legal representatives of the merging companies should prepare a plan of merger or adopt a merger resolution. The plan should include the terms, conditions and any other relevant merger matters. The resolution should indicate the effective date of the merger and include the financial statements that serve as the basis for the resolution.

— The merging entities should then discuss and approve the plan of merger by holding extraordinary shareholders' meetings.

— According to a recent amendment to the Consumer's Defense Law, the plan of merging entities must be submitted to the Promotion of Competition Commission for approval countersigned by the Ministry of Economy, Industry and Commerce, in cases where the assets or revenue of the merging entities exceed a specific amount (approximately 15.9 million US dollars (US$)).

— A notary public then must notarize the shareholder resolutions. A summary of the document must be published in the Official Gazette, and the corresponding testimony of the deed must be submitted to the public registry for registration.

The effects of the merger for legal purposes may take place 1 month after the publication in the Gazette and registration with the Public Registry.

Asset purchase or share purchase

Although capital gains are excluded from gross taxable income in Costa Rica in principle, where the gain is derived from a for-profit activity or related to the disposal of depreciable assets for consideration above their book value, the transaction is taxable.

For this reason, the purchase of shares of a local entity is common in Costa Rica because it may have more beneficial tax consequences than buying assets. Depending on the

circumstances, this is usually more beneficial for the seller than the buyer because there may be some limitations for a step-up in basis for the buyer. Income is subject to tax in Costa Rica where it is generated by performing an activity, using goods or investing funds within the country. Capital gains are normally not taxed unless they are generated from the transfer of tangible and depreciable assets or as a result of a habitual activity for the seller. Since shares are not depreciable assets, their transfer should not be subject to income tax.

However, where the seller has executed similar transactions in the past, the seller may be deemed to be performing a habitual activity and thus subject to income tax. In this case, income tax is imposed on the difference between the book value and selling price.

Purchase of assets

The most important consequence of purchasing assets is the increase in the tax base for depreciation and potential capital gains. For the seller, any gain derived from the transaction is taxable where depreciable assets are disposed of or where the seller is deemed to be engaged in a habitual activity.

Purchase price

The Treasury Department and Costa Rica's President issued Executive Decree N° 37898-H, which enacted transfer pricing rules in Costa Rica as of 13 September 2013. Currently, the tax courts are applying the transfer pricing rules based on the stipulations of the executive decree based on the approval by the Constitutional Court.

Goodwill

Article 9 of the Income Tax Law stipulates that goodwill paid for a business as a going concern cannot be deducted or amortized for income tax purposes.

Depreciation

The purchase price of the assets may be used to determine the depreciation expense of tangible assets that generate taxable income and the depreciation of permanent improvements. However, fixed assets must be depreciated at rates established in annex II of the Income Tax Law Regulations. Depreciation on the value of real estate is not accepted.

Tax attributes

Tax losses cannot transfer on an asset acquisition.

Value added tax

Value added tax (VAT) does not apply on sale of real estate or used assets.

Transfer taxes

A transfer tax of 1.5 percent is levied on the transfer of real estate. This tax is based on the declared value of real estate transferred or the value reported to the tax authorities, whichever is higher. Typically, both the buyer and seller of real estate are jointly liable for the tax, except where the contracting parties have agreed otherwise. The tax is assessed on the date the transaction is executed. Taxpayers must pay the tax within 1 month of the execution date.

The indirect transfer of real estate via the sale of shares of the entity owning the property is also subject to the 1.5 percent transfer tax. The law empowers the tax authorities to compute this levy on the value registered for tax purposes or the market value determined by the tax authorities.

Purchase of shares

Depending on how the purchase of shares is executed and taking into account specific provisions in the regulations to the Income Tax Law, it may be possible to allocate the price paid for the shares to the underlying assets, thus increasing future depreciation for the buyer. Otherwise, the acquisition as a purchase of shares may lead to the forfeiture of depreciation on the purchase price.

Tax indemnities and warranties

Any tax liability remains with the target entity but may be extended to the buyer company where the target entity is merged into the purchasing entity.

Tax losses

According to Article 8G of the Income Tax Law, tax loss carry forwards are only available to industrial and agricultural companies. Net operating losses incurred by commercial enterprises may not be carried forward.

For agricultural and industrial companies, the carry forward periods are 5 and 3 years, respectively. Industrial companies that began operations after 1988 are allowed to apply net operating loss carry forwards for 5 years when they start up operations. Losses incurred afterward may only be carried forward for 3 fiscal years.

The tax authorities only accept loss carry forwards where the losses are duly recorded for accounting purposes as deferred losses.

Pre-sale dividend

Costa Rican legislation has no specific rules on pre-sale dividends, so there is nothing to prevent the target entity from distributing dividends among its shareholders before the transaction.

Where the recipient of the dividend is an individual or a non-domiciled entity, a 15 percent withholding tax (WHT) applies.

Transfer taxes

Under article 272 of the Fiscal Code, stamp tax is due on private documents at a rate of 0.5 percent, generally based on the transaction's nominal value.

Where the transaction is only supported through an endorsement of the shares and the corresponding registration in the company's shareholder register, the stamp tax does not apply. A private contract that is executed in addition to those documents is subject to the stamp tax.

Where the document is executed outside of Costa Rica, the tax is deferred until the time when the document needs to be filed with a government office in Costa Rica. Since these types of contracts do not usually need to be filed with government offices, this tax may never have to be paid.

Choice of acquisition vehicle

Under current commercial law, the following potential vehicles are the most common in Costa Rica, and tax consequences may influence the selection:

— corporation (*Sociedad Anónima*)

— limited liability company (*Sociedad de Responsabilidad Limitada, Ltdas)*.

Because of their structural flexibility, corporations are the most common entity. Since local laws define a 'corporation' as a bilateral agreement, they must be formed by at least two parties. However, immediately after formation, a single party may legally own 100 percent of the shares without altering the legal status of the original corporation. To incorporate a legal entity, it is necessary to draft and execute a deed of incorporation before a notary public, publish notice of the incorporation in the official gazette, and register the incorporation deed in the public registry.

Founding parties (and any shareholders thereafter) may be individuals and/or any type of registered legal entity, regardless of citizenship and domicile.

A limited liability company is composed of partners whose liability is limited to their capital contributions. Incorporation procedures and costs are very similar to those of corporations.

The most significant differences between limited liability companies and corporations are as follows:

— *Share capital*: Limited liability companies divide their share capital into what local regulations call quotas as opposed to shares. Unless the articles of incorporation specify otherwise, a transfer of quotas requires the unanimous consent of all partners.

— *Management*: Limited liability companies are run by one or more managers or assistant managers who hold power of attorney as provided for in the articles of incorporation. Managers may also be owners of the company. By contrast, corporations are headed by a board of directors, which must have at least a president, treasurer and secretary. Typically, the president holds unlimited power of attorney for the company, although the shareholders may limit this power.

Local holding company

A local holding company may be useful since distributions of dividends among local entities are not subject to taxation.

However, Costa Rica tax legislation has no rules permitting tax consolidation.

Foreign parent company

An acquisition may be implemented using a foreign parent company, but any distribution of dividends from a local entity to a foreign parent is subject to a 15 percent WHT (see 'Group relief/consolidation' later in this report). Moreover, where the foreign parent company is a creditor of the local subsidiary, interest payments abroad are also subject to a 15 percent WHT. Most remittances abroad are subject to taxation according to territoriality principle (see the WHT rate table at the end of this report).

In addition, the deductibility of certain payments to a parent company, regardless of its domicile, is limited to no more than 10 percent of the subsidiary company's gross income. Such payments include payments for interest, royalties, franchises, trademarks and technical advisory services.

Non-resident intermediate holding company

Currently, Costa Rica has only two treaties in force for the avoidance of double taxation, which were signed with Spain and Germany. A tax treaty with Mexico has been signed, and its ratification is pending in Congress. Tax treaties are the only instruments in Costa Rica that a non-resident holding company can use to avoid double taxation and access reduced WHT rates on the distribution of dividends and other remittances abroad.

Local branch

Current legislation requires all legal entities to register with the public registry. There is no difference in the tax treatment of a subsidiary and a branch.

Joint venture

Costa Rican commercial and tax legislation include no rules specific to joint ventures. From a tax standpoint, a joint venture is no different from its parties where it is structured as a contractual agreement. Where the joint venture takes the form of a jointly owned company, the parties involved are treated as shareholders of a new entity. The tax courts have stated that tax returns from merging entities must be filed separately.

Choice of acquisition funding

The tax consequences of an acquisition funded by debt or equity are explained below.

Debt

The deductibility of interest for income tax purposes is the main advantage of funding an acquisition with debt. Taxpayers may also be able to deduct other financial expenses, such as commissions.

For foreign currency liabilities, the local entity is required to compute the conversion into local currency at the end of the fiscal year. The resulting exchange differential accrued during the tax year is recognized as a deductible loss where such liabilities are related to the entity's ordinary course of business. Conversely, any income recognized in the accounting records as being derived from an exchange rate differential is taxed as income.

The deductibility of expenses is subject to the following general requirements:

— The expenses must be necessary to obtain taxable income.

— The company must have withheld and paid the taxes established in the Income Tax Law as required.

— Supporting documentation must be duly authorized by the tax authorities.

The tax authorities are empowered to reject any expenses treated as deductible where they consider that:

— The expenses are not necessary for generating taxable income.

— The expenses are excessive or unreasonable.

— The expenses do not correspond to the income tax return being filed.

— There is inadequate supporting documentation for the expenses.

— The expenses have not been properly booked in the accounting records.

— WHT has not been withheld (if applicable).

Deductibility of interest

From the perspective of the domiciled entity, interest payable on a loan may be tax-deductible where there is a connection between the loan and the generation of taxable income in Costa Rica.

Therefore, it is important that the loan is and can be shown to be necessary for the business. Appropriate evidence might include financial statements demonstrating the need to finance the company's activities, develop new projects for which it has insufficient capital, or any other reason that satisfies the substance requirements. These requirements must be reasonable and proportional.

The tax authorities closely scrutinize loans granted by related entities or shareholders.

The parties should ensure they have evidence on hand to prove the substance and necessity of the transaction.

According to the Income Tax Law, a Costa Rican limited liability company may not deduct interest for income tax purposes where the loan was granted by its quota holders (*cuotistas*), as such a loan is considered similar to a distribution of dividends.

Withholding tax on debt and methods to reduce or eliminate it

Where the lender is a non-resident, payments of interest from a domiciled party are subject to a 15 percent WHT.

Where the lender is a non-resident and no WHT was paid on interest received from the local borrower, the tax authorities may reject the borrower's interest deduction and charge the applicable WHT.

Where a local financial institution subject to oversight by the General Superintendency of Financial Institutions pays interest to another financial institution subject to oversight in its country of residence, the WHT rate is 5.5 percent.

Interest paid to a foreign bank that forms part of a local financial group or conglomerate is subject to WHT at the following rates:

— 5 percent for the year 2014–15

— 9 percent for the year 2015–16

— 13 percent for the year 2016–17

— 15 percent for the year 2017–18 and later years.

Interest paid to a multilateral development bank or a bilateral or multilateral development agency, or any others exempted by law, are not subject to WHT.

Checklist for debt funding

— A Costa Rican limited liability company may not deduct interest for income tax purposes if its quota holders granted the loan.

— Companies should evaluate the reasonability and terms and conditions for deductibility of interest, as well as the need for such debt to offset against taxable profits in Costa Rica.

Equity

Costa Rican commercial legislation includes no rules on equity contributions by shareholders, except share capital, which is the only type of capital contribution regulated by the Code of Commerce. Share capital is stated (and eventually amended) in the entity's articles of incorporation. It is divided into common par value shares, each entitled to one vote. Shares must be registered, as local regulations prohibit bearer or non-par value shares. Article 18 of the Mercantile Code stipulates that the shareholders are obliged to include a share capital clause in the articles of incorporation, stating the amount of the share capital and the form and term in which it should be paid.

Share capital can be increased or reduced as agreed by the shareholders. To effect such changes, the shareholders must amend the corresponding clause of the articles of incorporation at a shareholders meeting, register it in the minutes book of shareholders and later record it with the public registry.

However, it is common practice for shareholders to provide equity in the form of additional paid-in capital. Equity contributions through additional paid-in capital should be recorded in the minutes book of shareholders — but need not be recorded with the public registry. It can be argued that additional paid-in capital is not a legal term. However, from an accounting perspective, it still has to be recorded as an equity contribution and is broadly recognized as a normal practice in Costa Rica.

Share capital and additional paid-in capital are both registered as equity but in different accounts.

Finally, additional paid-in capital is not necessarily intended to increase share capital. The contribution may remain recorded in the entity's accounts with no term or be refunded to the shareholders. Since shares do not support the additional paid-in capital contribution (and so the shareholder funding the entity is not obtaining the voting and economic rights inherent to share capital), a substantial contribution of additional paid-in capital does not generate dividends or confer more voting rights.

Refund of share capital or additional paid-in capital is not subject to tax. However, such contributions and refunds should be aimed to provide a relatively stable capital for the company. Otherwise the tax authorities may interpret the existence of a loan subject to WHT on imputed interests.

Hybrids

Costa Rican mercantile and tax legislation include no regulations on hybrid instruments. It is possible to convert additional paid-in capital into a loan granted by the shareholders. However, this should not be taken to imply that additional paid-in capital could be considered as a hybrid instrument under Costa Rican legislation.

Other considerations

Concerns of the seller

Since capital gains are normally not subject to taxation (unless derived from habitual activities), the seller normally seeks to structure the transaction as a purchase of shares. Care must be taken to ensure the transaction cannot be construed as a habitual activity.

Company law and accounting

The Costa Rican Code of Commerce stipulates the requirements under which local corporations and limited liability companies must operate.

From a tax standpoint, duly registered entities acting as ordinary taxpayers should discharge the following formal duties:

— Register with the tax authorities as an ordinary taxpayer at the moment business activities start.

— File an income tax return within 2 months and 15 days of the end of the tax year.

— Keep accounting books. Article 53 of the Regulation of the Income Tax Law Accounting requires companies to maintain journal, ledger and balance and inventories books in Spanish, in chronological order, in Costa Rican colones (CRC) and in compliance with International Financial Reporting Standards. Companies are required to issue electronic invoices that are directly reported and recorded in the tax authorities.

— Make quarterly advance payments by the last working days of March, June and September. These payments should be calculated on the taxable income of the preceding year or the average of the tax paid in the last

3 years, whichever is higher. Where the taxpayer has not declared any income in the previous year, the quarterly payment should be based on any other returns it has filed. For the first filing, the taxpayer should provide an estimate of their annual income in January of that year. The 75 percent of the average thus computed should be divided into three equal parts to produce the quarterly advance payments due on the quarter dates. The annual tax return should be filed 2.5 months after the end of the tax year (usually 15 December), and the tax should be paid after crediting the advance payments. Any excess tax paid as a result of this procedure could be used as a tax credit to offset liabilities generated from other taxes managed by the same tax administration. Where no other tax is owing or a balance remains available after offsetting all other taxes, a refund may be requested, typically in the form of a tax credit balance that may be used to offset future tax obligations, including WHT.

— Respond to any inquiry or information request by the tax authorities. The tax authorities are empowered to audit any taxpayer within the statute of limitations (4 to 10 years, depending on the circumstances of the taxpayer).

Failure to register with the tax authorities does not exempt the entity from its tax obligations. The Standards and Procedures Tax Code determines the fines applicable in each case for non-compliance with these obligations.

As noted, current legislation stipulates that the accounting records and the local financial statements must be kept in CRC. However, for the purposes of reporting to a non-domiciled parent company, the local company can translate its accounting records.

Additionally, in accordance with Article 81 of the Income Tax Law, where the local company carries out operations in a foreign currency that affect its taxable income, the company is obliged to record the transaction for tax purposes in national currency by using the reference exchange rate established by the Central Bank of Costa Rica at the moment the operation took place or the income was received, recording any exchange rate differential gain or loss as a taxable or deductible expense, respectively.

For assets and liabilities denominated in foreign currency, the branch is required to compute the conversion into CRC at the end of the fiscal year. The resulting exchange differential accrued during the tax year is recognized as taxable income or a deductible loss, provided such assets or liabilities are related to the company's ordinary course of business.

Group relief/consolidation

According to Article 18 of the Costa Rican Income Tax Law, the distribution of dividends from a domiciled entity is subject to a 15 percent WHT where paid to domiciled individual or to a non-resident parent company. However, no WHT applies where dividends are paid to another local corporate entity that is also subject to corporate income tax.

Costa Rica tax legislation does not allow tax consolidation.

Transfer pricing

As of 13 September 2013, Executive Decree N° 37898-H, which regulates transfer pricing in Costa Rica, is in effect. This decree is based on the Organisation for Economic Co-operation and Development transfer pricing guidelines on transactions (goods and services) between related parties and follows the arm's length principle. The tax authorities are entitled to apply the comparability analysis/methodology and compel the taxpayer to apply a transfer pricing method that supports the estimated price of the transaction.

The decree requires the taxpayer to file a transfer pricing analysis on the related parties' executed transactions annually. In addition, companies are required to prepare a master file that should be kept available to the tax authorities on request.

Other BEPS actions

In addition to the OECD regulations on transfer pricing local file and master file, Costa Rica has adopted country-by-country reporting, the Common Reporting Standard, and the Multilateral Instrument for the tax treaties with Spain, Germany and Mexico. In addition, the tax authorities continuously incorporate new elements of the BEPS actions to support the substance-over-form principle stated in article 8 of the Tax Code.

Foreign investments of a local target company

Costa Rica's income tax system is based on the territoriality principle. Any income obtained from activities performed, goods located or funds invested within the national territory are subject to tax. As a consequence, income from outside Costa Rica generally should not be subject to taxation, although some exceptions apply. However, if any income is generated abroad based on the implicit or explicit direction or management from Costa Rica, it is considered subject to tax in this country.

Income obtained locally and paid, credited (in the payer's accounting books) or made available in any way to non-resident entities is subject to WHT on the gross amount remitted

abroad. This tax liability is final. The rates vary according to the nature of the income concerned.

Costa Rica's tax system includes no controlled foreign company rules.

Legal entity tax

In accordance with the newly published Legal Entity Tax Law, corporations, limited liability companies, branches of foreign corporations and individual limited liability companies that are or will be registered with the Costa Rican Public Registry are subject to an annual tax calculated with a schedule generating a liability not exceeding US$400.

Non-compliance with this tax for 3 consecutive periods is considered as cause for dissolution of the legal entity.

Withholding taxes

Under Article 1 of the Income Tax Law, Costa Rican-sourced income is any income obtained from the provision of services, goods located or funds invested within the national territory. Article 23 of the Income Tax Law establishes which income is taxed at the source by means of tax withholdings, such as salaries, interest, other yields from securities and other passive financial investment income, dividends, payments of Costa Rican-source income paid to non-residents.

Therefore, WHT on remittances abroad arises whenever Costa Rican source income is paid, accredited or otherwise placed at the disposal of non-resident individuals or corporate entities. The source of funds and form of payment are not relevant for tax purposes. Income that derives from activities performed within the country is considered taxable.

The tax must be withheld at the time it is settled, credited or made available to the non-domiciled person; it must be paid within 15 calendar days of the immediately following month.

Comparison of asset and share purchases

Advantages of asset purchases

— Purchase price can be depreciated for fixed assets. Goodwill or intangible assets cannot be amortized for income tax purposes.

— No previous liabilities of the seller are inherited.

— Possible to acquire only part of the assets.

Disadvantages of asset purchases

— Not attractive for the seller (due to taxation on the transfer of assets), so the price may be higher.

Advantages of share purchases

— In principle, the disposal of shares is not taxable, so the price could be lower.

— A transfer of shares does not trigger transfer tax on real estate.

Disadvantages of share purchases

— Previous tax liabilities of the targeted company are inherited.

— Amortization of goodwill is not deductible for income tax purposes.

— No consolidation for tax purposes.

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Mexico

Introduction

Foreign investment in Mexico by multinationals has substantially increased over the past decade, thanks partly to the extensive network of tax and trade agreements concluded, particularly in recent years, with Mexico's most important financial and trading partners. These include the United States (US), Canada, some Central and South American countries, the European Union (EU) and some Asian countries. The main purposes of these agreements are to prevent double taxation on income and capital and eliminate custom duties in international trade.

The devaluation of the Mexican peso against the US dollar along with regulatory changes in the energy and telecommunication sectors are fueling cross-border merger and acquisition (M&A) activity led by foreign private equity firms and multinational companies. For all these reasons, new investment by multinationals expanding their operations in Mexico is expected to continue to grow strongly over the next few years.

This report discusses the main issues that should be considered by companies seeking tax-efficient structures in Mexico.

Recent developments

As part of a major 2016 tax reform and additional reforms for the energy sector, the following important changes were introduced.

Thin capitalization for the electricity industry

For purposes of the thin capitalization provisions, which restrict the deduction of interest on debt with non-resident related parties, debt obtained in order to invest in infrastructure for electrical power generation is excluded from the thin capitalization calculation.

New information tax returns for transfer pricing

In the context of base erosion and profit shifting (BEPS), there are proposals that would expand Mexico's transfer pricing disclosure requirements. In particular, a measure would require certain taxpayers (as identified pursuant to Article 32-H) that engage in transactions with related parties to submit to the tax authorities certain country-by-country information about the taxation of their business transactions. In addition to a transfer pricing study, taxpayers with income higher than 708.8 million Mexican pesos (MXN) must file informative tax statements about their related parties.

Common Reporting Standard

In order to meet its international commitments to tackle BEPS, Mexico adopted the 15 July 2014 proposal of the Organisation for Economic Co-operation and Development (OECD) that would require financial institutions to automatically report information under the Common Reporting Standard (see article 32-B of the Mexican Federal Fiscal Code — MFFC). This new article establishes, among other things, the terms and conditions that financial institutions should adopt to meet the new standard and the sanctions applicable for non-compliance.

Specific changes related to the energy sector

Secondary legislation to the Energy Reform, which entered into force on 1 January 2015, includes a new Hydrocarbons Income Act (HIA). The main provisions of the HIA are as follows:

- The objective of the legislation is to establish a regime for income from fees, royalties, bonuses and contractual contributions that the Mexican state will receive from private companies carrying out extraction and exploration activities of hydrocarbons through government contracts or through assignments. Such companies are also required to pay income tax.
- For income tax purposes, instead of applying the normal tax depreciation rates for investments in certain depreciable fixed assets, the following tax depreciation rates are to be used:
  - 100 percent for investments made for exploration, secondary recovery and improvement, and non-capitalized maintenance
  - 25 percent annually for investments made for the development and exploitation of oil and natural gas deposits
  - 10 percent annually for investments in storage infrastructure and essential transportation assets, such as oil and gas pipelines, terminals, storage transport and tanks.
- The OECD transfer pricing guidelines are applicable to contractors carrying out activities with related parties,

such as the sale or commercialization of hydrocarbons and the procurement of materials, supplies or services.

— Assignors selling oil or natural gas to related parties or incurring costs, expenses or investments through operations with related parties must use prices or consideration that independent parties would agree to in comparable transactions, and they must apply the transfer pricing provisions of the income tax legislation. The values used for sales of oil and gas to related parties must be determined using the comparable uncontrolled price method.

— A 0 percent value added tax (VAT) rate will apply to activities established in certain contracts.

— Tax losses may be carried forward for up to 15 tax years for taxpayers carrying out activities in marine regions with a water depth of more than 500 meters.

— Non-residents carrying out any of the activities regulated by the HIA within Mexican territory or the Mexican exclusive economic zone are deemed to have a permanent establishment in Mexico when such activities are carried out for a period that exceeds 30 days in any 12-month period. Activities carried out by a related party of a non-resident are included in the determination of the 30-day period, provided the activities are identical, similar or part of the same project.

— Wages and salaries paid by non-residents (where there is no permanent establishment in Mexico or no salaries and wages connected to such permanent establishment) to non-resident employees for work related to HIA-regulated activities of contractors or assignors are subject to Mexican income tax, provided the activities are carried out within Mexican territory or the Mexican economic exclusive zone for a period that exceeds 30 days in any 12-month period.

Asset purchase or share purchase

An acquisition in Mexico can take the form of an asset deal or a share deal.

According to the Mexican tax rules, on a business acquisition, the seller and buyer share jointly in liabilities incurred by the business during the 5 years leading up to the acquisition. Mexican laws do not define the term 'business'. According to the tax authorities, a sale of a business occurs when a company sells or otherwise disposes of the assets and liabilities that were used to develop the core business of a company. Another indication that a transfer of a business has occurred is the simultaneous transfer of employees to the company acquiring the assets and liabilities. This joint liability is limited to the purchase price paid for the assets.

If the acquisition of assets is properly planned and reviewed by tax and legal advisors, the transfer of a potential tax risk can be mitigated. By contrast, on a purchase of shares, the historical liabilities remain with the company acquired. Some of the tax considerations relevant to each method are discussed later in the report, and their respective advantages are summarized at the end of the report.

Purchase of assets

An acquisition of assets increases the cost of the transaction, because the transaction is normally subject to VAT. When the buyer is a Mexican resident, this additional cost may be refunded. In addition, tax for the transfer of real estate property may apply. From a tax perspective, however, the acquisition of assets preserves the tax basis for the buyer and may result in a reduced tax basis for corporate income tax purposes.

Purchase price

For tax purposes, it is necessary to apportion the total consideration among the assets acquired. It is generally advisable for the purchase agreement to specify the allocation, which is normally accepted for tax purposes provided it is commercially justifiable. The Mexican rules are very formal and, in addition to the contract, require proper invoices supporting the acquisition of assets and detailing the amount of the VAT triggered on the acquisition.

Goodwill

Goodwill purchased from a third party is not deductible for tax purposes in Mexico. According to the criteria used by the tax authorities, goodwill is the excess paid for the assets over their real value, nominal value or fair market value.

Depreciation

For tax purposes, depreciation of acquired tangible and intangible assets must employ the straight-line depreciation method at the maximum rates specified for each asset in the Mexican income tax law. Among others, applicable rates are as follows:

— 5 percent for buildings

— 10 percent for office furniture and equipment

— 25 percent for automobiles, buses, trucks, tractors and trailers

— 30 percent for personal desktop or portable computers, servers, printers, optic readers, digitalizers and computer networking hubs.

There are special rules for cars and certain intangible assets, such as royalties.

Tax attributes

In the case of a sale of assets in Mexico, the tax attributes of the company (i.e. tax losses and tax credits) are not transferred to the acquirer of the assets.

Value added tax

As previously mentioned, the purchase of assets (goods) is subject to VAT. The general VAT rate is 16 percent.

Purchase of shares

The purchase of a target company's shares does not represent a deduction for corporate income tax. In a share deal, no VAT is applicable.

Tax indemnities and warranties

In a share acquisition, the buyer takes over the target company together with all related liabilities, including contingent liabilities. Therefore, the buyer normally requires more extensive indemnities and warranties than in the case of an asset acquisition. The alternative approach, to inject the seller's business into a newly formed subsidiary, does not work in most cases because of the joint tax liability for the transfer of a business under Mexican law.

A full due diligence investigation is essential in a share deal. When significant sums are identified as potential tax contingencies as a result of the due diligence exercise, it is common for the buyer to require the establishment of an escrow amount from which the seller can draw on an agreed schedule.

The Mexican tax authorities are entitled to examine and assess additional taxes for any year, at any time within a 5-year period commencing on the day after taxes were due or tax returns were filed, including amended returns. If the taxpayer has deducted tax losses from taxable profits, the tax authorities are entitled to examine and assess the information relating to the losses, regardless of how they were generated, for up to 5 years after the amortization of the loss.

Tax losses

After a change in control, the losses of an entity acquired can only be used against income from the same line of business that generated the losses. The carry forward period is 10 years.

Crystallization of tax charges

Since tax authorities may claim joint liability of the buyer for unpaid taxes in the last 5 years, it is essential to obtain an appropriate indemnity from the seller in addition to the escrow amount.

Pre-sale dividend

In certain circumstances, the seller may prefer to realize part of the value of their investment as income by means of a pre-sale dividend. This is common in Mexico because such pre-sale dividends are not usually subject to corporate income tax where the company retains sufficient funds in its 'pre-2014 net after-tax profits account' (CUFIN, by its Spanish acronym). A case-by-case analysis must be carried out when the dividend payment exceeds the amount of the CUFIN. Under the 2014 tax reform, individuals residing in Mexico and non-resident persons who receive dividends or profits generated in 2014 and after must pay an additional 10 percent tax. This tax is paid through withholding by the legal entity that distributes or pays the dividends.

Choice of acquisition vehicle

Several potential acquisition vehicles are available to a foreign buyer, and tax factors often influence the choice. There is no capital duty in Mexico.

Local holding company

A Mexican holding company is typically used where the buyer wishes to carry out an asset deal. In a share deal, however, changes introduced in the 2014 tax reform have reduced the ability to push down debt to the Mexican holding vehicle.

Foreign parent company

A foreign parent company is commonly used in a share deal. International corporations completing a stock or asset purchase through a foreign vehicle should evaluate:

— participation exemption regulations in foreign countries

— interest deduction in foreign countries

— goodwill deduction

— passive income accrual

— controlled foreign company (CFC) rules

— entity classification for foreign tax purposes

— exit strategies

— debt pushdown to Mexico.

Exit strategies that exempt Mexican corporate income tax withholding on any capital gain derived from the transfer of Mexican operations include:

— completing the transaction with a subsidiary in a country with which Mexico has signed a tax treaty providing exemption from capital gains tax on the sale of shares (e.g. France, Italy)

— setting up an intermediate holding company in a foreign country that can be sold, so that no transfer of Mexican shares occurs. In this case, the Mexican shares should not derive, directly or indirectly, more than 50 percent of their value from real property located in Mexico. If they do, the transfer is taxable in Mexico, unless the Belgium or Luxembourg treaty applies.

Non-resident intermediate holding company

If the foreign country taxes capital gains and dividends received from overseas, an intermediate holding company resident in another territory could be used to defer this tax and perhaps take advantage of a more favorable tax treaty with Mexico. However, the buyer should be aware that many Mexican treaties contain treaty-shopping provisions that may restrict the ability to structure a deal in a way designed solely to obtain tax benefits.

Local branch

A branch it is not used as a vehicle of acquisition in Mexico due to several tax inefficiencies.

Joint venture

A joint venture may be used for the acquisition. In Mexico, the joint venture is only available at the corporate level, with the joint venture partners holding shares in a Mexican company. Mexican rules do not distinguish between a joint venture vehicle and a Mexican holding company for tax purposes.

Choice of acquisition funding

As of 2005, Mexican tax law applies thin capitalization rules such that interest paid to foreign related parties that results in indebtedness exceeding a ratio of 3:1 to their stockholders' equity is not deductible for corporate income tax purposes.

Foreign investment may be financed with debt or equity at the investor's discretion. Some issues that should be considered when evaluating the form of the investment are discussed below.

Debt

The most important benefit of financing through debt instead of equity is the interest deducibility for corporate income tax purposes in Mexico.

Debt considerations for corporate income tax purposes include the following:

— Interest payments made on 'back-to-back loans', as defined under Mexican tax law, may be treated as dividend distributions.

— The Mexican borrower may be subject to inflationary income resulting from the loss on the purchase value or the Mexican currency.

— The Mexican borrower may deduct any foreign exchange losses on the principal and interest components.

— Transfer pricing rules apply. Any interest that exceeds arm's length interest in intercompany transactions is treated as a dividend distribution and is non-deductible.

Deductibility of interest

Mexico's thin capitalization rules require taxpayers to maintain a debt-to-equity ratio of 3:1. The ratio includes all interest-bearing debt. The equity is determined according to Mexican generally accepted accounting principles (GAAP) and excludes the income or loss of the same year (e.g. equity is calculated as the sum of accounting capital at the beginning and end of the relevant year divided by two). Interest paid in excess of the ratio is disallowed for income tax purposes.

When such interest is paid to a lender abroad, such non-deductible interest is still subject to withholding tax (WHT).

Moreover, interest paid to a foreign controlling or controlled entity from Mexico is not deductible where:

— the foreign entity is transparent for tax purposes and its members are not subject to income tax in their country

— the payment is non-existent for that foreign entity, or

— the interest revenue is not taxable for the foreign entity.

Under Mexican domestic tax legislation, all taxpayers are required to price their transactions with related parties on an arm's length basis. When transactions are carried out with foreign-based related parties, taxpayers must also prepare and maintain documentation that supports the arm's length price by identifying related parties and disclosing information about the functions, risks and assets associated with each type of transaction performed with related parties.

Withholding tax on debt and methods to reduce or eliminate it

Interest is considered to be Mexican source where the capital is placed or invested in Mexico or where the party paying the interest is a Mexican resident or a non-resident with a permanent establishment.

WHT rates applicable to interest paid vary depending on the foreign beneficiary, the borrower domiciled in Mexico and the purpose of the loan.

WHT rates are as follows:

— A 4.9 percent WHT rate may apply in the case of loans or other credit payable by Mexican financial institutions, as well as loans placed through banks in a country with which Mexico has a tax treaty.

— The WHT rate is 10 percent for finance entities owned by foreign governments and foreign banks, including foreign investment banks and non-bank banks, provided they are the effective beneficiaries of the interest and provided they submit to the Mexican tax authorities the information required under the general rules on financing granted to Mexican residents. Non-bank banks should also comply with the requirements established by the tax authorities relating to placement percentages and deposits received.

— The WHT rate is 21 percent for foreign suppliers who sell machinery and equipment forming part of the acquirer's fixed assets.

— The WHT rate is 21 percent for financing to acquire machinery and equipment and in general to supply working capital, provided these circumstances are mentioned in the agreement.

— The WHT rate is 35 percent for other interest (e.g. loans granted by foreign-related parties). This rate may increase to 40 percent as discussed below.

Payments of interest by a Mexican resident to a foreign related party subject to a preferential tax regime (tax haven) are subject to 40 percent WHT. Despite the above rates, tax treaty rates should be observed. As noted in the table at the end of this report, the highest tax treaty rates for general interest payments are 15 percent and 10 percent, depending on the terms negotiated with each country and whether the treaty includes a most-favored-nation clause.

Withholding is triggered when payment is made or when interest is due, whichever occurs first.

Checklist for debt funding

— It is difficult to implement debt pushdown strategies in Mexico.

— To identify the optimal amount of debt to be allocated to Mexico, it is necessary to carry out projections for corporate income tax.

— The use of bank debt may avoid thin capitalization and transfer pricing problems, but back-to-back loan restrictions may apply.

— Maximum WHT applies on interest payments to non-Mexican entities unless a lower rate applies under a relevant tax treaty.

Equity

When incorporating a new company, there is no capital duty in Mexico. However, Public Registry recording obligations may apply. According to Mexican income tax law, the income obtained by the corporation from capital increases is not taxable, but such increases of capital in Mexican or foreign currency must be reported with a detailed return filed within 15 days of the receipt of the capital. Transfers of goods to the capital of another company are taxed as sales, and corporate tax may be triggered on gains derived from the transfers.

No currency restrictions apply in Mexico, so capital contributions and repatriations can be achieved in foreign currency. However, from Mexican legal and tax standpoints, once the capital contribution in foreign currency is made, it is converted into Mexican currency. Therefore, if the Mexican currency suffers a substantial devaluation, the foreign investor may suffer a loss in foreign currency terms.

Capital repatriations in the form of share redemptions are not subject to exit capital duties and can be effected tax-free for the shareholder up to the amount of contributed capital per share. However, when a profit is determined from a capital redemption that exceeds the capital contributions account balance (CUCA by its Spanish acronym), the additional 10 percent tax applies where the profit was not generated before 1 January 2014.

In an alienation of shares or security instruments representing the ownership of property, the source of wealth is deemed to be located in Mexico where the issuing entity resides in the country or where more than half the accounting value of said shares or security instruments is derived directly or indirectly from real property located in the country. Income tax would be assessed at 25 percent on the gross amount without any deduction, or 35 percent on the gain. The latter treatment is only applicable where certain requirements are met, such as where the non-resident (seller) has a representative in Mexico, the non-resident's income is not subject to a preferential tax regime, and the non-resident files an audit prepared by a certified public accountant (CPA) with the tax authorities. In the case of a related-party transaction, the CPA must report the market value of the alienated shares in the audit. The buyer must make the withholding if it is a resident or a non-resident with a permanent establishment in Mexico. Otherwise, the taxpayer must submit the applicable tax by a return filed with the authorized offices within 15 days of the receipt of the income.

According to Mexican tax provisions, a domestic merger may be carried out tax-free where the following conditions are met:

— The surviving company files a notice of the merger with the tax authorities no later than 1 month following the date on which the merger is approved by the shareholders.

— Following the merger, the surviving company continues to carry out the activities that it and the merging companies carried out before the merger for a period of at least 1 year following the date on which the merger was completed.

— The surviving company files all tax and information returns on behalf of the merging companies for the fiscal year in which the merger is completed, including payment of any tax liability at the date of the merger.

— Finally, reorganizations may be carried out on a tax-free basis in certain cases; however, further analysis of the details of the reorganization is required.

Other considerations

Concerns of the seller

The tax position of the seller can significantly influence the results of the transaction. As discussed previously, in certain circumstances, the seller may prefer to realize part of the value of their investment as income by means of a pre-sale dividend, if the company has a sufficient balance in its pre-2014 net after-tax earnings account.

Many companies in Mexico are family businesses. The disposal of the shares of such businesses is commonly taxed at an individual rather than a corporate level. This is important because the seller generally looks to pay reduced taxes on the transaction and may propose arrangements that could cause

tax contingencies for the company being acquired. Therefore, it is advisable at the outset of the process to identify the transaction structure proposed by the seller in order to evaluate its tax implications and reduce potential delays.

Company law and accounting

Legal entities may be organized in various forms under Mexican law:

— *Sociedad en nombre colectivo* — the usual general partnership form.

— *Sociedad en comandita simple* — a limited partnership with some general partners (having unlimited liability) and some limited liability partners; its capital is represented by social interests.

— *Sociedad en comandita por acciones* — a limited liability stock partnership with some general partners (having unlimited liability) and some limited liability partners; its capital is represented by shares.

— *Sociedad de Responsabilidad Limitada* (S. de R.L.) — a partnership with limited liability for all its members; its capital is represented by social interests.

— *Sociedad Anónima* (S.A.) — an entity similar to a US corporation in which all members have limited liability; its capital is represented by common shares.

— *Sociedad Anónima Promotora de Inversión* (SAPI) — a new type of entity for investors organized in general terms as an S.A. but exempt from certain obligations, which gives shareholders additional rights; recommended for joint venture projects and entities that may become publicly listed companies.

— *Sociedad de Acciones Simplificada* (SAS) — an entity constituted by one or more individuals who are only obliged to pay their contributions represented in shares; the total annual income of this entity may not exceed MXN5 million. Its capital is represented by common shares.

General partnerships lack limited liability, so foreign investors do not often use them. Although an S de R.L. is treated in the same way as any other commercial entity for Mexican tax purposes, it may be treated for US tax purposes as an eligible entity for partnership status; as such, its US partners, whether corporate or individual, benefit from the pass-through taxation rules.

The S.A. is the most common entity used by foreign investors in Mexico, and discussions in the rest of this report focus on the S.A. Both an S.A. and an S. de R.L. may be incorporated on the variable capital (de capital variable) model, which enables the capital to be increased or decreased by simple shareholders' or partners' resolution, without further formalities. The shareholders may extract their contributions to the variable capital without any special formalities, but they cannot withdraw their shares of the fixed capital, which must be maintained at the minimum mandatory level.

M&A in Mexico should be accounted for according to the Mexican financial reporting standards (FRS), which generally are consistent with International Financial Reporting Standards (IFRS). There are some differences, however, which include the following:

— Under IFRS, if the value of net assets acquired exceeds consideration and any retained minority interest, a gain is recognized. Mexican FRS does not allow the recognition of any gain until intangible and fixed assets values are adjusted to zero.

— Under Mexican FRS, the seller's contingent liabilities are recognized when payment is deemed to be probable and the amount can be reasonably estimated. Under IFRS, the seller's contingent liabilities are recognized if fair value can be reasonably estimated.

— Under IFRS, when an entity obtains control through a series of acquisitions (step acquisitions), it should revalue any previously held equity interests at its acquisition-date fair value and record any gain or loss through the operating statement. New guidance for Mexican FRS does not allow the recognition of any gain or loss when control is obtained through step acquisitions.

New grouping regime

If the buyer owns other Mexican companies, the target company can be included in the Mexican tax group if certain requirements are met. Among others, the Mexican holding company should own, directly or indirectly, more than 80 percent of the voting shares of the target company. In no case can more than 80 percent of the Mexican holding company's voting shares be held by another or other companies, unless the latter are residents of a country with which Mexico has a treaty that includes a broad information exchange clause.

The new grouping regime does not allow the inclusion of entities with non-operating losses, and the tax deferment period is reduced to 3 years (from 5 years).

Transfer pricing

Mexico's income tax law requires all taxpayers that execute transactions with related parties to undertake a transfer pricing study to demonstrate that their transfer prices honor the arm's length principle.

Dual residency

There are no advantages under Mexican tax law for a dual resident company.

Foreign investments of a local target company

Mexico, in common with other countries, has established anti-tax haven provisions to close a loophole that both Mexican and foreign investors had used to allocate income to tax havens and so reduce their Mexican taxable income. The legislation is designed to prevent Mexican taxpayers from

deferring Mexican income taxes by using preferential tax regimes or tax havens. Currently, the anti-tax haven provisions encompass all types of investments by a Mexican resident, both direct and indirect.

The definition of tax haven or preferential tax regime has been amended to include any regime where taxes paid are less than 75 percent of the amount that would be paid in Mexico. Income accrual does not apply where:

— income is derived from activities other than interest, dividends, royalties, gains on the sale of shares, real property or the temporary use or enjoyment of real property, and

— the country in which the investment is located has a current treaty for the broad exchange of information with Mexico.

Income from a foreign source that is subject to a WHT reduction or exemption under a tax treaty executed with Mexico is disregarded for income tax purposes. This treatment does not apply to legal entities incorporated abroad that are not taxpayers or that are deemed transparent for tax purposes.

Direct and indirect Mexican investors in preferential tax regimes are obliged to recognize the income on a current basis and file an annual information return on their business and their investment activities in such jurisdictions.

Renewable energy industry

Mexican Income Tax Law allows the deduction of 100 percent of machinery and equipment for energy generation from renewable sources or cogeneration systems of efficient electricity, provided the machinery and equipment are used for at least 5 years immediately following the year in which the deduction is claimed.

In a measure that aims to attract investment in renewable energy projects in Mexico, entities that are eligible for this deduction are able to distribute tax-free dividends against future profits through the creation of a "green net after-tax profit account" (CUFIN verde).

Obtaining tax treaty relief

In the case of transactions with related parties, the tax authority is now authorized to require formal documentation from the non-resident to show that there is double taxation on the income for which a treaty benefit is being applied. The documentation must specify the applicable provisions of foreign law and include any other documentation that may be deemed necessary.

Comparison of asset and share purchases

Advantages of an asset purchase

— Any VAT paid may be refunded if the buyer is a Mexican resident.

— A step-up in the tax basis of fixed assets and intangible property is allowed for income tax purposes.

— There is no transfer of seller's liabilities, except in the case of an acquisition of the overall trade or business. However, strategies are available that avoid this contingency.

— The vehicle can be properly designed from the beginning, including exit strategies.

Disadvantages of an asset purchase

— Time required for setting up the vehicle to complete the asset purchase.

— Employees transferred typically demand seniority recognition from the new employer unless they receive a severance payment from the old employer.

— Property transfer taxes may apply.

— Goodwill paid is not tax-deductible.

— VAT may increase the cost of the transaction in certain circumstances.

Advantages of a share purchase

— Less time-consuming process.

— Usually more attractive to the seller, both commercially and from a tax perspective (because the disposal may be exempt), so the price may be lower.

— Transfer of tax loss carry forwards and other tax credits is allowed.

— No real estate transfer tax.

— The acquisition of shares is not subject to VAT.

Disadvantages of a share purchase

— Buyer effectively becomes liable for any claims or previous liabilities of the entity, including tax (i.e. there is a joint liability for unpaid taxes over the previous 5 years).

— No income tax deduction for the purchase price.

— Deferred tax liabilities are acquired.

— Possibly more difficult to finance tax-efficiently.

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Panama

Introduction

The signing of several free trade agreements (FTA) and the ambitious Panama Canal expansion are tangible signs that Panama is opening its economy to the global market. As a result, Panamanian companies are working to increase their competitiveness. Mergers and acquisitions (M&A) are increasingly common in Panama in recent years, and they are seen as the best way for companies to position themselves in the regional and global economies. Panama's largest banks have merged during a period of strong growth in practically every industrial sector, and this growth is expected to continue.

Merger procedures in Panama are mainly governed by Law No. 32 of 1927, which regulates corporations in general, and also by Executive Decree 18 of 1994, which sets out the accounting procedures that must be applied to effect a tax-exempt merger.

Demerger procedures are governed by Law 85 of 2012, which is applicable to corporations regulated by the Commerce Code. These provisions allow for tax-free demergers if taxpayers meet certain conditions, basically that:

— corporations involved in the demerger procedure are owned by the same shareholders

— any assets involved in the demerger procedure are transferred at book value.

Recent developments

Some recent legal developments relating to M&A include the opinion to demerge corporations based on Law 85 of 2012 and the entry into force of a number of conventions for the avoidance of double taxation.

In the last several years, Panama has signed such tax treaties with the following countries: Barbados, Czech Republic, France, Ireland, Israel, Luxembourg, Mexico, the Netherlands, Portugal, Qatar, Singapore, South Korea, Spain, United Arab Emirates, United Kingdom and Italy (all of which are now in effect). The provisions of these treaties may benefit merger procedures involving companies that are resident in states with which Panama has signed tax treaties.

On 24 January 2018, Panama signed the Multilateral Convention to implement Tax Treaties related to prevent Base Erosion and Profit Shifting (BEPS). With this signing, Panama has shown its intention to comply with OECD standards and cooperate with the international community regarding tax matters.

Asset purchase or share purchase

Sales of shares and assets are subject to a 10 percent capital gains tax. However, there are certain advance taxes that may reduce even further the capital gain tax.

In Panama, most acquisitions take the form of share purchases. This usually results in lower taxes because buyers are required to withhold 5 percent of the transfer price as an income tax advance. The seller can regard this advance as the final tax, which is often lower than the tax that would have been paid if the 10 percent rate were levied on the actual gain arising from the sale of shares or assets.

In some cases, 10 percent of the gain from the sale of the assets can be less than 5 percent of the purchase price of the shares. In these circumstances, tax refunds are available if certain conditions are met. Also, acquisitions by means of an asset purchase are preferable in these circumstances unless a tax treaty provides for a lower capital gains tax on the sale of shares or exempts the transaction altogether.

Purchase of assets

The taxable income in a real estate purchase is the purchase price less the basic cost of the asset, the value of the improvements made to it and the costs associated with the sales operation. As of 17 September 2009, taxpayers are obliged to pay an income tax advance equivalent to 3 percent of the total value of the transfer or the cadastral value, whichever is higher. This advance can be considered as the final tax; however, if the advance is higher than the result of applying the 10 percent rate to the profit arising from the transfer, the seller could file a tax refund or tax credit request.

If such tax is paid, the income from the sale is not considered as part of the company's taxable income subject to the ordinary 25 percent corporate tax rate. This provision aims to

protect natural persons from being taxed at inappropriately high rates because of abnormally high personal income resulting from the sale of a property. For companies, the provision establishes a sort of preferential regime for the transfer of real estate.

Purchase price

Previously, Panama imposed no rules to set the prices at which such transactions should be made. Panama enacted transfer pricing legislation that largely follows the Organisation for Economic Co-operation and Development (OECD) transfer pricing guidelines. Compliance with these rules should be considered when setting the price of transactions between related parties.

Goodwill

Income tax regulations allow the deduction of certain intangibles, although not specifically goodwill. Certain challenges made by the Tax Administration in this regard are currently under review by the Administrative Tax Court. The main requirement for the deduction of the intangibles amortization is that the transaction must be taxable for the party that has transferred the intangibles.

Depreciation

Panamanian tax regulations allow three main methods of depreciation calculation. Taxpayers are not required to apply the same depreciation method to all of their assets. The three methods are:

1. straight-line method
2. decreasing balance method
3. sum-of-digits method.

Taxpayers could also use other methods for some or all of their assets, provided the method is considered as appropriate for the specific industry.

Buildings and improvements have a minimum depreciation period of 30 years, while the period is 3 years for other fixed assets.

Tax attributes

In most situations, mergers have no effect on fiscal rights or benefits or on the amortization of assets that can be used by the new company in the future. However, any losses carried forward by the absorbed entity are not deductible by the surviving company.

Value added tax

The sale of real estate is not subject to Panama's value added tax (ITBMS by its Spanish acronym), which is levied at a rate of 7 percent on the transfer of movable goods and the provision of services. Asset purchases are generally subject to ITBMS if assets other than immovable property are involved in the transaction (e.g. equipment, machinery, vehicles). Mergers that take place in accordance with Executive Decree No. 18 of 1994 are specifically excluded from ITBMS.

Transfer taxes

Mergers in accordance with Executive Decree No. 18 of 1994 are not subject to stamp tax. The transfer of real estate is subject to a 2 percent transfer tax.

Mergers under a share purchase agreement are subject to stamp tax. The tax does not apply to mergers under an asset sale agreement, provided ITBMS has been applied.

Purchase of shares

The sale of shares, bonds and other securities is taxable if they relate to entities that have activities in Panama that generate taxable income or capital economically invested in the country. Income from a public stock offering is treated as capital gains and taxed at a fixed rate of 10 percent.

The buyer must withhold 5 percent of the purchase price and remit it to the tax authorities within 10 days of the payment date as an advance income tax payment. The seller is entitled to consider the withheld amount as the final income tax payment.

If the advance sum exceeds 10 percent of the capital gain, the seller can submit a request to the tax authorities for the excess to be deemed an income tax credit for the year in which the sale of shares took place.

The tax treatment may be affected by the application of a tax treaty, which may grant a more favorable result.

Tax losses

Capital losses are not considered deductible against ordinary income. The tax loss carry forward of a company that is absorbed in a merger may not be applied by the absorbing entity.

Pre-sale dividend

If a company with undistributed profits is about to be sold, in some cases, it may be better to distribute such profits, pay the corresponding dividend (10 or 5 percent) tax and deduct the profits from the sale price. Distributing the profits reduces the taxable basis for the 5 percent capital gains withholding.

Since, in most cases, the company has already paid the dividend tax advance (known as complementary tax), the applicable dividend tax is a maximum of 6 percent (rather than 10 percent). This may result in a lower overall tax than would have been the case if the company were simply sold without distributing the retained profits. The dividend tax may be reduced or exempted by an applicable tax treaty.

Transfer taxes

The share purchase agreement would be subject to stamp tax at a rate of 0.10 per 100 US dollars (US$) of the purchase price stated in the agreement.

Choice of acquisition vehicle

There are several possible acquisition vehicles, but some are more convenient than others. The characteristics of each vehicle are summarized below.

Local holding company

A Panama holding company must pay dividend tax at the rate of 10 or 5 percent on the dividends it received from the purchased company depending on the source of the profits. The tax is withheld at source. The holding company can then distribute the profits to its shareholders without further tax payments.

Foreign parent company

A foreign company is subject to a dividend tax on the acquired Panamanian entity's distributed profits. Panamanian corporate law does not allow mergers between local and foreign entities unless the foreign entity is itself registered in Panama.

Panama has signed tax treaties with a number of countries (see recent developments earlier in this report and the table at the end of this report). Panama's tax treaty network should be considered when establishing a foreign parent company.

Non-resident intermediate holding company

A non-resident intermediate holding company is also subject to the dividend tax and cannot be merged with the Panamanian entity.

As noted, Panama's tax treaty network should be considered when establishing a foreign parent company.

Local branch

For corporate law purposes, the local branch of a foreign entity is not considered as a Panamanian company, so a merger cannot be accomplished. The foreign company would need to change its domicile to Panama for corporate purposes in order to be a part in a merger process.

Joint venture

Joint ventures are considered in Panama's commercial law as *sociedades accidentales*, and they are typically used as non-corporate vehicles for the development of infrastructure projects. Joint ventures are not considered as persons from a legal standpoint, which limits their usefulness for holding purposes.

Choice of acquisition funding

The buyer may choose to fund the acquisition with either debt or equity. The characteristics of each option are summarized below.

Debt

When funding a merger with debt, interest deductibility and withholding taxes are key factors that must be taken into account.

Interest on loans provided for the acquisition of shares is not deductible because the holding company would generate dividend income subject to a special regime (i.e. dividend tax withheld at source).

For asset purchases, interest is deductible for the entity bearing the financing and taxable for the recipient.

Deductibility of interest

The acquiring company cannot deduct the interest paid on a loan obtained to purchase the shares of the acquired company. Merging both entities may create an opportunity to deduct interest incurred in the acquisition.

Withholding tax on debt and methods to reduce or eliminate it

Interest, commissions and other charges paid to foreign creditors on loans or financing are subject to a 12.5 percent effective income tax rate, which the debtor must withhold. Since Panama now has a number of tax treaties in force, it is possible to reduce the withholding.

Equity

Capital contributions are not taxable, but any capital reduction shall be preceded by a distribution of any retained earnings.

Note that Panama does not tax the issue of shares or corporate capital contributions.

Deferred settlement

If the shares will be paid in several installments over a period of time, it could be agreed that such shares are to be transferred in separate packages, with capital gains tax assessed on each batch.

Other considerations

The buyer is obliged to withhold 5 percent of the transfer price as an income tax advance. If not, the tax authorities can demand either the selling company or the target company to pay the corresponding tax.

Concerns of the seller

The seller's main concern is the lengthy process to obtain a tax refund where the 5 percent withholding made by the buyer turns out to be higher than 10 percent of the actual gain.

Company law and accounting

Mergers that do not comply with the above provisions are considered as taxable transactions. The merger agreement between the merging companies must comply with the provisions of Law 32 of 1927, which regulates companies. For the merger to become effective, the agreement must be registered at the public registry.

All registered properties of the merging companies should be registered under the name of the surviving or merged company, according to the merger agreement and subject only to the payment of the applicable public registry rates.

The Directorate General of the Revenue should be informed of a merger within 30 days of its registration at the public registry. The surviving or merged company acquires the tax

obligations of the merging companies but cannot deduct the merging company's losses.

Mergers by creation (consolidation) are subject to the rates for registering a new company, and mergers by absorption are subject to the rates for registering the increase of authorized capital, if any, of the surviving company. Where there is no increase in capital, the applicable rate is the rate for registering company minutes.

Shareholders of the extinguished company are not subject to income tax, income tax on dividends or complementary tax if they only receive share certificates in return for the shares they held in the extinguished company. They also are exempt from the above-mentioned taxes where they receive small cash payments to avoid the elimination of the surviving company's stock, as long as the payments do not exceed 1 percent of the value of the shares received by the shareholders in return of their shares in the extinguished company.

Demergers governed by Law 85 of 2012 are tax-free if certain conditions are met by taxpayers, basically that:

— corporations involved in demerger procedure are owned by the same shareholders

— any assets involved in the demerger procedures are transferred at book value.

Foreign investments of a local target company

Mergers involving one or more foreign companies are recognized by the Commercial Code, subject to the condition that those companies are registered with the Public Registry of Panama. Where the surviving company is a foreign company, a 5-year period of registration is required after the merger has taken place.

Comparison of asset and share purchases

Advantages of asset purchases

— If the capital gain is low, the 10 percent tax on the gains would be lower than the 5 percent tax that would apply on the total value of a share transfer.

Disadvantages of asset purchases

— The transfer of real estate is subject to a 2 percent transfer tax.

— The transfer of movable property (e.g. machinery, equipment, vehicles) is subject to the 7 percent ITBMS (Panama's value added tax).

— The tax is ultimately levied on the capital gain at a rate of 10 percent. The taxpayer is still obliged to pay 3 percent of the total value of the transfer as capital gains tax; where this amount is higher than 10 percent of the actual gain, a refund or a tax credit may be requested from the Tax Administration.

Advantages of share purchases

— Seller may choose to treat the 5 percent withholding on the purchase price as the final tax.

— Transfer is not subject to any other taxes.

Disadvantages of share purchases

— In some circumstances, the 5 percent withholding on the transfer value exceeds the 10 percent of the actual gain. The withholding must still be made and the seller must then apply to the Tax Administration for a refund. The refund process may be lengthy.

— Challenges related to the pushdown of goodwill and/or debt should be carefully analyzed.

Panama — Withholding tax rates

This table sets out reduced WHT rates that may be available for various types of payments to non-residents under Panama's tax treaties. This table is based on information available up to February 2018.

Source: Double taxation treaties signed by the Revenue Office of Panama, 2018

	Dividends		Interest[1] (percent)	Royalties (percent)
	Individuals, companies (percent)	Qualifying companies[2] (percent)		
Domestic rates				
Companies:	0/5/10/20[3]	N/A	0/25[4]	0/25
Individuals:	5/10/20	N/A	0/15/25[5]	0/15/25[5]
Treaty rates				
Treaty with:				
Barbados	7.5[6]	5[6]	5/7.5	0/7.5[7]
Czech Republic	10	10	5/10	10
France	15[17]	5	5	5
Italy[18]	10	5	5/10[8]	10

	Dividends		Interest[1] (percent)	Royalties (percent)
	Individuals, companies (percent)	Qualifying companies[2] (percent)		
Ireland	5	5	5	5
Israel	5/15[18]	20[19]	0–15[20]	15
Korea (Rep.)	15[17]	5	5	3/10[9]
Luxembourg	15[17]	5/10[10]	5	5
Mexico	7.5	5	5/10[11]	10
Netherlands	15[17]	0[12]	5	5
Portugal	15[17]	10	10	10
Qatar	6	0[13]	6	6
Singapore	5	4	0/5[14]	5
Spain	10	0/5[15]	0/5[16]	5
United Arab Emirates	5	5	5	5
United Kingdom	15[17]	0	5	5

Notes:

1 Many treaties provide for an exemption for certain types of interest, e.g. interest paid to the state, local authorities, the central bank or specific credit institutions.

2 These rates generally apply when a minimum participation in the voting power or capital is met by the beneficial owner.

3 The 0 percent rate only applies when the company does not carry out any taxable activities in Panama and only generates foreign source income. The 5 percent rate applies to dividends arising from foreign source profits. The 10 percent rate applies to dividends arising from Panamanian source profits. The 20 percent rate applies to bearer shares.

4 Subject to (final withholding) taxation at the general corporate or personal income tax rate on 50 percent of the gross amount. Effective corporate WHT rate is 12.5 percent.

5 Individuals are subject to progressive tax rates ranging from 0 to 25 percent, which is applied on 50 percent of the gross amount.

6 This rate does not apply to dividends paid on bearer shares.

7 The 0 percent rate applies to royalties including scientific work related to biotechnology industry, literary work and cinematographic work.

8 The 5 percent rate applies to interest paid to the banks.

9 The 3 percent rate applies to royalties from the use of, or the right to use, industrial, commercial or scientific equipment.

10 The rate applies with respect to direct participations of at least 10 percent of capital.

11 The lower rate applies to interest paid to banks.

12 The 0 percent rate applies with respect to participations of at least 15 percent of the capital of the company paying the dividends, and to participations of pension fund.

13 The 0 percent rate applies to dividends paid to the other state, local authorities, the central bank, pension funds, investment authorities or any other state-owned institution or fund.

14 The 0 percent rate applies to interest (i) paid to the government; and (ii) paid to banks.

15 The 0 percent rate applies with respect to participations of at least 80 percent of the capital (additional specific conditions apply). The 5 percent rate applies with respect to participations of at least 40 percent of the capital.

16 The 0 percent rate applies to interest (i) (paid to or) by the state, local authorities or the central bank; (ii) paid to specific credit institutions; and (iii) interest paid on sales on credit and (iv) pension funds.

17 Although these treaties allow a rate of 15 percent, Panamanian domestic law only allows for a rate of up to 10 percent. Dividends paid out of bearer shares could be subject to a 15 percent rate instead of 20 percent, but, in some treaties, dividends are not covered by treaty benefits and are therefore taxed at the ordinary 20 percent rate.

18 The 5 percent rate applies to pension plans.

19 For direct participations of at least 10 percent of capital, the rate cannot exceed the 20 percent rate. However, Panamanian domestic law only allows for a rate of up to 10 percent.

20 The 0 percent rate applies to (i) contracting state, central bank or any local authority if they are the effective beneficiary; (ii) if the interest is paid by the government, central bank or local authority; (iii) pension plan; and (iv) corporate bonds listed on a stock market of the contracting state.

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Uruguay

Introduction

Competitive forces in the global economic environment are increasingly causing companies to consolidate their operations. As a result, mergers and acquisitions (M&A) have become an important component of business strategies throughout the world. Uruguay is no exception to this rule.

Recent developments

The Uruguay tax system includes a non-resident income tax (IRNR) which applies on Uruguayan-source income obtained by non-residents. This tax requires withholding on certain payments made abroad by local companies, including dividends, interest, royalties and technical fees. Capital gains resulting from the disposal of local assets (including shares) by a non-resident are also considered taxable, except for bearer shares, which are subject to an exemption.

In 2017, new tax rules came into force and effect for foreign companies located in low- or no-tax jurisdictions (as listed by the local tax office). These changes include an increase to 25 percent (from 12 percent) in the IRNR rate applicable on certain payments made abroad (e.g. interest, technical services and royalties) and some exceptions to the source principle (e.g. capital gains from the sale of shares from foreign holding companies located in low- or no-tax jurisdictions are considered of Uruguay source — and thus taxable — when more than 50 percent of their assets are located in national territory).

Asset purchase or share purchase

Asset purchases and share purchases, the two main options for acquisitions, have different legal and tax consequences in Uruguay, as explained later in the report.

Purchase of assets

In most cases, the purchase of substantial assets of an existing business falls within the category of a transfer of a commercial establishment, requiring a special procedure to be followed under Laws 2.904 and 14.433. According to court precedents, the concept of substantial assets includes those that, on being transferred, would make it impossible for the transferor to continue developing its business as before.

This procedure is quite lengthy and complex, involving a promise to sell the commercial establishment, a request for special certificates from the Tax and Social Security Offices, and the convening of a meeting of the seller's creditors by means of special publications.

Purchase price

The proceeds from a sale of local assets are subject to corporate income tax.

Goodwill

The difference between the purchase price and the fiscal value of the transferred assets is considered goodwill for tax purposes (the fiscal value of an asset depends on its nature and may or may not be equivalent to market value).

Depreciation

The fiscal goodwill is booked as an asset by the buyer, but it is not depreciated or revalued.

Other assets must be booked at the same fiscal value used by the seller and are subject to the general rules for depreciation and revaluation.

Tax attributes

Tax losses are not transferred to the buyer.

Value added tax

Generally, the transfer of local assets resulting from the transaction is subject to value added tax (VAT). This tax is levied at a basic rate of 22 percent, with a lower rate of 10 percent for a prescribed list of goods and services (some items are exempt). The fiscal goodwill is also subject to VAT at the basic 22 percent rate.

Transfer taxes

There is no stamp duty or stamp duty land tax in Uruguay. An acquisition that includes a transfer of real estate is subject to real estate transfer tax, levied at the rate of 4 percent (2 percent each for the buyer and seller) on the cadastral value of the real estate (a notional value established by the National Direction of Cadaster).

Purchase of shares

The transfer of shares takes place through a simple procedure (basically by their simple delivery in the case of bearer shares or through their endorsement in the case of nominative titles).

Tax indemnities and warranties

When the buyer purchases a company, it takes over all its tax liabilities, existing or contingent. Therefore, the buyer usually protects itself from eventual contingencies by commissioning a due diligence investigation of the target's affairs, including its tax affairs, and by requiring contractual tax indemnities and warranties from the seller.

Tax losses

The tax losses of the purchased company are not affected by the sale of its shares.

Choice of acquisition vehicle

Several potential acquisition vehicles are available to the foreign buyer.

Local holding company

A local holding company is not normally suitable for a purchase of shares because it does not produce any tax advantages in Uruguay. Moreover, apart from investment companies (entities whose main business consists of investment activities), local companies cannot participate in the capital of other entities for a value that exceeds their net worth.

Foreign parent company

Foreign parent companies are used most frequently as acquisition vehicles by foreign investors. Dividends received from Uruguay are subject to IRNR withholding (discussed later in this report), and gains on a subsequent disposal of the shares of the local company, notionally established at 20 percent of the selling price,[1] are taxable under IRNR.

Non-resident intermediate holding company

From the Uruguayan viewpoint, non-resident intermediate holding companies do not generate any tax advantage.

However, they can be a useful alternative from an exit strategy perspective, because the sale of shares from a foreign company that holds shares from a local entity is not taxable in Uruguay unless the foreign company is located in a low/no tax jurisdiction and more than 50 percent of its assets are located in the national territory.

Local branch

A local branch of a foreign company is considered a permanent establishment (PE) of the foreign entity. Uruguay applies the force of attraction principle, under which all income obtained in Uruguay by the foreign entity must be imputed to the PE (whether or not it has participated in obtaining it). The effects of this rule should be carefully evaluated before choosing a branch structure for investment purposes.

Joint venture

A joint venture is not a separate entity in itself but rather a contractual arrangement. Its use should be analyzed case-by-case.

Choice of acquisition funding

The buyer needs to decide whether to fund its acquisition with debt or equity. Some factors to be considered when making this decision are discussed below.

Debt

The principal attraction of debt is the potential tax deductibility of interest. Uruguay has no thin capitalization rules, but other aspects of the Uruguayan tax regime may limit such deductibility.

Deductibility of interest

As indicated in previous sections, under Uruguayan corporate income tax rules, deductibility of expenses is conditional on their taxability as income to the counterparty.

This general rule also applies to interest. Assuming all income of the local company is of Uruguay source, the deductibility is determined by the difference between:

— the IRNR withholding rate (12 percent[2]) plus the foreign tax rate applied to the interest in the foreign lender's country, and

— the corporate income tax rate of 25 percent.

Thus, 100 percent deductibility is only allowed where the IRNR withholding rate plus the foreign tax rate exceeds 25 percent.

Financing through debt generates additional tax effects for foreign currency gains or losses (where the loan is denominated in foreign currency), and inflation adjustment must also be taken into account. The combined tax effects of these external factors may be material but are difficult to predict in a particular case.

Withholding tax on debt and methods to reduce or eliminate it

Interest paid by a local company on foreign loans is subject to IRNR withholding at 12 percent.[3] However, interest is exempt for loans granted to local entities that employ more than 90 percent of their assets in obtaining non-taxable income.

Checklist for debt funding

— No thin capitalization rules.

— No restrictions on interest payments or currency exchange limitations.

— 12 percent IRNR withholding.[4]

[1] Where the seller is located in a low- or no-tax jurisdiction, this notional percentage is increased to 30 percent (from 20 percent), and the applicable IRNR tax rate is increased to 25 percent (from 12 percent).
[2] Increased to 25 percent for payments to low- or no-tax jurisdictions.
[3] See note 2.
[4] See note 2.

— Full deductibility by local company is conditional on foreign tax treatment.

— Additional effects from inflation adjustment and currency exchange are difficult to forecast and may result in taxable gains.

Equity

A buyer may also fund its acquisition through equity. The disadvantage of this approach is that there would be no interest to deduct and dividends are not deductible. But equity may be preferable for non-tax reasons, and the limitations on interest relief and the negative effects that might result from external factors such as inflation and currency exchange rates must also be taken into account.

For these reasons, no general rules can be established for the choice of debt or equity as alternatives for financing. Each case must be evaluated on its own merits.

Hybrids

There are no specific rules in Uruguay relating to hybrid instruments. Their potential use should be analyzed case-by-case.

Discounted securities

There are no specific rules in Uruguay relating to discounted securities. Their potential use should be analyzed case-by-case.

Deferred settlement

Uruguay has no specific provisions regarding deferred settlement, which is computed for tax purposes on its accrual.

Other considerations

In addition to the options considered earlier in this report, a legal merger may be used to acquire a local target.

Under article 26 of Law 16.906, the Executive Power can exempt merger transactions from applicable taxes (corporate income tax, VAT, real estate transfer tax) where the operation is likely to strengthen the activities of the companies involved. To obtain this exemption, a special request must be submitted demonstrating the economic purposes of the transaction.

Concerns of the seller

The tax position of the seller may be relevant when deciding how to structure the transaction, but there are no general rules.

Company law and accounting

Company Law 16.060 contains the main legal provisions applicable to commercial companies in Uruguay, including formation, operation, reorganization and dissolution.

Mergers are specifically regulated in article 115 and following articles 114 to 135, which stipulate that a merger by creation takes place when two or more companies dissolve without liquidation and transfer their whole net worth to a newly created company. A merger by absorption occurs when one or more companies dissolve without liquidation and transfer their whole net worth to a pre-existing company.

In both alternatives, the shareholders or partners of the merged companies receive as compensation shares, quotas or participations in the newly created or absorbing company.

A merger is decided by majority votes following the formal requirements of corporate by-laws, as amended.

A special balance sheet must be prepared by each of the merging companies before the competent corporate bodies can adopt the merging resolution. In preparing the special balance sheets, the merging companies should apply uniform criteria for the valuation of the assets and liabilities, the valuation date and the treatment of subsequent changes.

The decision to merge should be preceded by a promissory contract setting out the bases of the merger. Special publications of the promissory contract must be made for 10 days, summoning the shareholder and creditors.

Company creditors need to justify their credits within 20 days of the final publication. Creditors who oppose the merger must be paid or provided guarantees of payment.

Shareholders who oppose the merger may opt to leave the company within 30 days of the final publication and have their holdings paid for out of the special balance.

Once these notification periods have ended, the final merger contract will be executed and filed in the Register of Commerce.

Group relief/consolidation

Group relief or consolidation does not apply for tax purposes in Uruguay.

Transfer pricing

Uruguay introduced transfer pricing provisions in 2007 based on Organisation for Economic Co-operation and Development (OECD) guidelines. Uruguay's transfer pricing rules are regulated by a decree issued in 2009.

Foreign investments of a local target company

Uruguay generally applies the source principle for income taxation purposes, so foreign investments made by local companies are not subject to tax.

Comparison of asset and share purchases

Advantages of asset purchases

— Possible to isolate the purchasing entity from previous tax liabilities by following a special procedure (transfer of commercial establishment).

— Possible to acquire only part of a business.

Disadvantages of asset purchases

— The purchase procedure is fairly complex and lengthy (involving publications and obtaining special certificates from the tax authorities).

— The transaction is subject to local taxes, including corporate income tax, VAT and real estate transfer tax (if real estate is involved). Where the transaction is structured as a merger, the Executive Power may grant an exemption.

— Tax losses remain with the seller.

Advantages of share purchases

— The legal procedure for share transfers is simple and quick.

— Consent of third parties (e.g. creditors) generally is not required.

— No special certificates are needed from the tax authorities.

— From the legal viewpoint, the operation of the target company remains unchanged since the transaction is between the buyer and the shareholders of the target company.

— The fiscal costs are usually lower (e.g. sale of shares is VAT-exempt, real estate transfer tax does not apply, etc.).

Disadvantages of share purchases

Buyer acquires the target company with all its liabilities and contingencies (declared or not), so due diligence procedures have special importance and are normally more intense.

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Venezuela

Introduction

The Commercial Code is the basic law governing companies incorporated in Venezuela. Generally, companies and commercial associations have as their corporate purposes one or more commercial activities. However, Venezuelan law always attributes a commercial or business purpose to corporations and limited partnerships unless they are engaged exclusively in agriculture or cattle-raising activities.

Attributing a corporate purpose to a civil and commercial enterprise that is governed by its by-laws or articles of association, the Commercial and Civil Codes and special laws for particular business areas establishes its tax and legal characteristics.

Asset purchase or share purchase

An acquisition in Venezuela usually takes the form of a purchase of the shares of a company, as opposed to its business and assets, because capital gains on the sale of shares may be exempt, depending on tax treaty provisions.

Asset acquisitions are likely less attractive for the seller from a tax perspective due to the capital gains consequences, probable recapture of capital allowances (tax depreciation), and possible double taxation on extracting the sales proceeds. However, the benefits of asset acquisitions for the buyer should not be ignored. With a properly designed tax strategy, purchased goodwill may be tax-deductible.

Some of the tax considerations relevant to each method are discussed later in the report. The relative advantages are summarized at the end of the report.

Purchase of assets

A purchase of assets usually results in an increase in the base cost of those assets for both capital gains tax and capital allowances purposes, although this increase is likely to be taxable to the seller. Historical tax liabilities generally remain with the company and are not transferred with the assets. Because defective tax practices or compliance procedures may still be inherited, the buyer may wish to carry out some tax due diligence to identify and address such weaknesses.

Purchase price

The tax effect of an asset purchase is that the purchased assets have a cost basis for the buyer equal to the amount paid. The selling entity realizes a gain in the amount by which the purchase price exceeds the tax basis of the asset, including the inflation adjustment for entities except for those in the financial and insurance sectors and those classified as big taxpayers. An asset purchase may give buyers the opportunity to buy only the assets actually desired and leave unwanted assets (and sometimes unwanted liabilities) behind. An asset purchase may be highly advantageous where a target corporation has potential liabilities, although certain acquisitions of assets may involve an acquisition of a trading fund (see later in the report).

For tax purposes, it is necessary to apportion the total consideration among the assets acquired. It is generally advisable for the purchase agreement to specify the allocation, which is normally acceptable for tax purposes provided it is commercially justifiable.

Goodwill

Goodwill paid can be amortized for tax purposes over a term considered reasonable in the circumstances of each case.

Depreciation

Venezuela's Income Tax Law allows reasonable deductions for tax purposes to cover the depreciation of permanent assets and the amortization of the cost of other elements used in the production of the income, provided the assets are located in the country and such deductions have not been charged to cost. To calculate depreciation, similar goods with similar expected lives may be grouped together.

The Income Tax Law regulations define 'depreciation' as the loss of the useful value in the taxable year of permanent corporate assets used for the production of income, caused by obsolescence, wear or deterioration in use, and the effects of time and the elements.

Amortization of goodwill and other intangibles may be deducted as long as they are reasonable amounts paid in accordance with Venezuelan generally accepted accounting principles (GAAP).

Tax attributes

Tax losses and capital allowance pools are not transferred on an asset acquisition. They remain with the company or are extinguished. Where the buyer wishes to use a company's tax losses, it would have to enter into a profit-sharing agreement or merge with the target's ongoing business.

Value added tax

Sales of tangible goods, including any part of their property rights as well as withdrawals or retirements of movable goods by taxpayers, are subject to value added tax (VAT). VAT does not apply to sales of intangible goods, such as fiscal rights, stocks, bonds, mortgage bonds, mercantile effects, other securities and personal goods in general that represent money, credit or rights other than property rights over tangible goods.

Transfer taxes

Fees for the registration of deeds may arise from the disposal of a going concern (see 'Acquisition of trading fund or going concern' below) at the Subordinate Offices of Registry. Such fees generally amount to 2 percent where the value of the transaction exceeds 2 million Venezuelan bolivars (VEB).

The Stamp Tax Law also provides for an additional payment on the sale of a trading fund or its stocks, in their entirety or in lots, amounting to five tax units plus 0.2 tax units for each tax unit or fraction thereof applied to the price of the transaction.

Since the stamp tax was transferred from the national to the state taxing jurisdiction, the tax can vary, depending on the state in which the transaction is completed and registered.

Purchase of shares

A sale of a share of a Venezuelan company is a sale of rights on goods located in Venezuela, so income from their disposal is taxable in Venezuela.

Sellers are generally taxed on the excess of the purchase price over the tax basis in the shares sold. The tax rate on capital gains resulting from a sale of shares that are not publicly offered on the Venezuelan Stock Exchange ranges from 15 percent to 34 percent for corporations in general and 40 percent for insurance companies and financial institutions.

No specific regulations govern the sale price of shares, other than transfer pricing regulations and the concept of a reasonable cost basis. However, the Venezuelan Tax Administration may deem a price far below market price as a taxable event for the buyer for gift tax purposes.

The administration can also disregard the form in favor of the substance in cases where the incorporation and organization of entities, transactions, agreements or other legal business structures are adopted with the main purpose of reducing or avoiding taxes.

The deduction of any capital loss from the sale of shares carries the following conditions:

— Shares must be held for no less than 2 consecutive calendars years.

— The sale price must be in accordance with the market price or bear a reasonable relationship to the book value.

— The corporation whose shares are sold must have carried out reasonably significant economic activities during the 2 tax years immediately preceding the sale.

A disposal of Venezuelan shares is subject to withholding tax (WHT) of 5 percent of the amount paid.

Tax indemnities and warranties

In a share acquisition, the buyer is taking over the target company together with all related liabilities, including contingent liabilities. Therefore, the buyer normally requires more extensive indemnities and warranties than in an asset acquisition.

Where significant sums are at issue, it is customary for the buyer to initiate a due diligence exercise, which would normally incorporate a review of the target's tax affairs. However, there are a number of transactions where the principle of caveat emptor (let the buyer beware) normally applies and warranties and indemnities are not given. These situations typically include the acquisition of a Venezuelan quoted (listed) company, a purchase from a receiver or liquidator, and sometimes an acquisition of shares owned by individuals not involved in the management of the target.

Tax losses

In principle, carried forward Venezuelan tax losses generated by the target company transfer along with the company. A company's carried forward income-type losses (e.g. trading losses) cannot be offset against the profits of other companies through group relief because Venezuela does not allow consolidated tax returns. Carried forward losses can be offset against the company's own future profits. The alternative of merging the companies may serve for this purpose (see 'Merger' below).

Where a Venezuela target company with trading losses is acquired, whether directly or by the acquisition of its immediate or ultimate parent company, it may use those losses against its own future trading profits in the 3-year period after the loss was incurred.

The Venezuela Income Tax Law stipulates that carried forward net operating losses are authorized up to 3 years after the year in which the losses were incurred, provided the amount of the loss does not exceed 25 percent of the annual profits. Any losses from a foreign source may only be offset with income from foreign sources, on the same terms provided in the opening paragraph of this section.

Entities cannot carry forward net non-compensated losses arising from the adjustment for inflation.

Pre-sale dividend

Dividends are taxable on any distribution that exceeds the corporate taxable income. This treatment avoids double economic taxation for dividends. Any increase in the price of the share based on potential dividends is subject to capital gain tax rules.

Registration fee

It is not necessary to register a sale of shares, but the document of incorporation and by-laws must be modified to identify the new shareholder and the modification must be recorded with the Mercantile Registry Office, which may generate registration fees by way of tax units. The tax unit value is adjusted annually in line with changes in the consumer price index.

After a change of shareholders in the Venezuelan subsidiary, the corporation must notify to Ministry of the People's Power for Foreign Trade and Foreign Investment in order to update the register.

Stock sold on the Venezuelan Stock Exchange

Where the shares are sold on the Venezuelan Stock Exchange, the sale is taxed at a flat rate of 1 percent of the gross purchase price of the shares. This tax must be withheld at source by the stock exchange on sale.

Any loss arising on the sale of these shares cannot be deducted from the taxpayer's other earnings. Accordingly, such losses can never be used.

Tax clearances

Acquisition of trading fund or going concern (*Fondo de Comercio*)

Venezuelan law defines a 'trading fund' as the set of goods organized by a merchant for the performance of their business activities, including both material objects (e.g. capital, physical facilities) and intangible items (e.g. clientele, trademarks, name).

A trading fund is the gathering of goods and services linked by a common economic purpose, that is, a going concern. However, a trading fund cannot be considered a good per se, separate and apart from its component assets. Accordingly, its transfer takes the form of the transfer of each of its components. There is no integrated transfer of an entity.

The Venezuelan Commercial Code provides that the disposal of a trading fund occurs where:

— There is an ownership transfer of the trading fund or of the assets in their entirety or in lots.

— The transfer is completed by an inter vivos act, regardless of whether it takes the form of a sale, donation, exchange or contribution.

— The seller ceases to be involved in the business of the trading fund.

Venezuelan courts have held that the cessation of a business need not refer to the entire seller's productive activity; it is sufficient for the seller to cease engaging in the business involved in the trading fund being transferred.

On the sale of a trading fund, the acquiring company is obliged to withhold income tax at a rate of 5 percent of the amount paid for acquisition of the trading fund.

The tax law stipulates that the acquirers of a trading fund are jointly liable for any unpaid tax, fines and interest, limited to the value of the goods acquired. The tax administration can request payment of tax debts for a period of 1 year from the date the operation was notified.

Transfer taxes

Fees for the registration of deeds may arise on the disposal of a trading fund at the Subordinate Offices of Registry. Such fees generally amount to 2 percent of the value of the transaction.

The Stamp Tax Law (Article 3, Part 8) provides for an additional payment on the sale of a trading fund or its stocks, in their entirety or in lots, amounting to 5 tax units plus 0.2 tax units for each tax unit or fraction thereof applied to the price of the transaction.

Since the stamp tax was transferred from the national to the state taxing jurisdiction, the tax can vary, depending on the state where the transaction is completed and registered.

Choice of acquisition vehicle

Several potential acquisition vehicles are available to a foreign buyer, and tax factors often influence the choice.

Local holding company

A Venezuelan holding company can be used for Venezuelan subsidiaries in cases where it can be anticipated that dividend income will not be taxable as it would come from profit taxed at the corporate level. There are also other options involving transparent tax entities within a group that allow consolidation of the taxable income or result from the group into the holding company. A Venezuelan holding company is required to structure a share acquisition with the intention to use potential goodwill arising from the original acquisition.

Foreign parent company

According to the Venezuelan Commerce Code, companies domiciled abroad are considered foreign companies, regardless of whether their primary business operations are carried on in Venezuela. Foreign companies may adopt the following forms:

— subsidiary company (a company with its own legal nature, independent from the parent company)

— branch

— representative office

— permanent establishment (PE) not registered.

The most common structures used by foreign companies are the subsidiary company and the branch.

A subsidiary company can be established without any change in the amount of registered foreign investment. The incorporation of subsidiaries must be reported to the Ministry of the People's Power for Foreign Trade and Foreign Investment.

For a foreign company to establish a branch, the company must register its Articles of Incorporation with the Mercantile Registry, translated into Spanish by a public interpreter and legalized by the Venezuelan consulate in the country of origin. The company must also indicate the capital allocated to the branch, which must be brought into the country and registered with the Ministry of the People's Power for Foreign Trade and Foreign Investment.

This ministry provides the certifications to permit foreign investments in Venezuela to obtain the certifications that permit enjoy the benefits included in the law to encourage foreign investment. Due to a recent amendment, to qualify as a foreign investment for this purpose, the contributions must be equivalent to 800,000 euros (EUR), 6,500,000 Chinese yuan (RMB) or their equivalent in another foreign currency, reduced in some cases to 10 percent of those amounts. Where it is not possible to register the foreign investment, operations can still be established in Venezuela, although the benefits allowed for certified foreign investments will not be available.

Non-resident intermediate holding company

An intermediate holding company resident in another country could be used to take advantage of a more favorable tax treaty with Venezuela, provided the effective beneficiary and tax-resident principles are complied with. Venezuelan tax law contains anti-treaty shopping provisions that may restrict the ability to structure a deal in a way designed solely to obtain tax benefits.

Venezuelan branch

A foreign company needs to be registered in the Mercantile Registry to perform activities in Venezuela. It can choose to act through an affiliate or a branch. A PE with a legal representative does not require registration in the Mercantile Registry.

A branch is subject to tax under the corporate tax regime and to the equivalent of a dividend tax (branch profit tax) of 34 percent flat (other than hydrocarbons) of the excess of 'financial profits' (as defined by Venezuelan GAAP) over taxable profits, which the branch must pay annually on behalf of stockholders. Where profits are reinvested for a term of at least 5 years, this tax does not apply.

In determining the net income of the branch, local and foreign administration and management expenses can be deducted. However, payments to the parent company or related company for technical assistance, fees and royalties or rights to use patents or other rights or commissions are not deductible, unless they reimburse actual expenses.

Joint venture

A consortium or joint venture is a form of association in which two or more companies act together under one direction and common rule, each conserving its nature and legal independence. The consortium has a tax identification number. Generally, all of its members are jointly liable. The terms of a joint venture may vary, depending on the private agreements and purposes of the partners. For example, either gross income or net results could be selected as the variable for determining distributions to its members.

Choice of acquisition funding

Generally, an acquiring corporation funds an acquisition with debt, equity or a combination of both. Interest on debt is usually allowed as a deduction to the paying corporation, provided the capital is used in Venezuela to finance the corporation's regular taxable operations.

Debt

The principal advantage of debt is the potential tax-deductibility of interest for the buyer (see the information on deductibility of interest later in the report). Another potential advantage of debt is the deductibility of expenses, such as guarantee fees or bank fees, in computing trading profits for tax purposes. By contrast, the costs of a share issue are not deductible.

For entities subject to the inflation adjustment system, debt may generate an inflation gain where it finances non-monetary assets. Thin capitalization rules must be taken into account because interest deductions could be limited where the debt-to-equity ratio is deemed to be excessive.

If it is decided to use debt, further decisions must be made as to which company should borrow and how the acquisition should be structured. To minimize the cost of debt, there must be sufficient taxable profits against which interest payments can be offset. The buyer cannot offset the interest payments against the Venezuelan target's taxable profits.

Deductibility of interest

To be deductible, interest expenses must correspond to capital used to fund normal operations that produce taxable income.

Interest on a loan used to acquire shares may be rejected because dividend income is considered net income subject to a proportional tax rate. However, since a capital gain on the disposal of shares is ordinary income, the interest expense attributable to such a loan could be deductible.

Interest paid to related companies abroad is subject to transfer pricing provisions. The thin capitalization rule also limits the deduction of interest on debts with foreign-related parties. For interest on borrowings from related entities to be deductible, total debt should not exceed the net equity (1:1 ratio). Venezuelan law employs the concepts of average net equity and average unrelated debts.

Withholding tax on debt and methods to reduce or eliminate it

Payments of interest by a Venezuela company to a non-resident financial institution are subject to WHT at 4.95 percent. Payments of interest to other non-resident entities are subject to WHT of 34 percent of 95 percent of the interest paid. The rate of WHT may be reduced or eliminated under a tax treaty.

Checklist for debt funding

— The use of independent bank debt may avoid thin capitalization and transfer pricing problems.

— Consider whether the level of profits would enable effective tax relief for interest payments.

— A tax deduction may be available at higher rates in other territories.

— WHT of 4.95 percent applies on interest payments to non-Venezuela financial institutions; WHT of 34 percent of the interest is levied on loans from other non-Venezuela entities unless a lower rate applies under the relevant tax treaty.

Equity

Generally, entities subject to the inflation adjustment system that are highly funded by equity either produce inflation tax losses or have a neutral inflation exposure. Inflation adjustment on equity and contributions to equity produce tax losses that can be offset against operating income in a tax period.

The thin capitalization rules allow the tax authority to re-characterize debt as equity and disallow interest deductions on the portion of the debt re-characterized. In some cases, this could be beneficial because of positive inflation effects.

Paid-in capital requires registration and triggers stamp tax on capital registered ranging from 1 to 2 percent.

Hybrids

Certain preferred shares may qualify as debt for tax purposes, based on the substance-over-form approach stipulated in the tax law.

Discounted securities

Market discounts are generally accepted for tax purposes.

Structuring the transaction

Choice of entity

The Venezuelan Commercial Code provides for four types of company:

— stock corporation, the most common form of corporation used in Venezuela to do business

— limited liability company

— partnership

— limited partnership.

Corporation (*Sociedad Anónima — S.A., or Compañía Anónima — C.A.*)

A corporation must be established with at least two shareholders. Once established, a corporation may continue to exist with one shareholder. A corporation's liabilities are guaranteed by the authorized corporate capital.

Limited liability company (*Sociedad de Responsabilidad Limitada — SRL*)

In an SRL, the social obligations are guaranteed by an authorized capital divided into participation quotas (units), which may not be represented by shares or negotiable titles. SRL capital must be at least VEB20 and at most VEB2 thousand. Additional capital contributions can be allowed as a surplus. Each participation quota must have a value of at least VEB1. The partners must contribute the amount of the corporate capital in cash or pay 50 percent of the contributions in kind. Currently, the Mercantile Registry does not allow the incorporation of this type of entity.

Partnership

A general partnership is a group of individuals who come together with the purpose of conducting business operations through a partnership entity. The partnership's obligations are backed or secured by the unlimited and joint liability of each partner. Each partner's individual liability is unlimited. Partners are liable not only up to the amount of their respective contributions but also up to the amount of their personal wealth that has not been contributed to the partnership. Liability is joint because the creditors can enforce their rights against any of the partners for the entire amount owed.

Limited partnership (*Compañía en Comandita*)

A limited partnership is also a society of persons. In this case, the partnership's obligations are secured by the joint, unlimited and subsidiary liability of a type or class of partners designated as active or joint partners and by the limited liability (up to a defined amount) of another category of partners designated as silent partners. The capital of the silent partners may be divided into shares.

Other business arrangements

Business can also be carried out through other legal and independent vehicles as described below.

Participation accounts (Cuenta en Participación)

A partner or corporation may grant a contract, referred as share profit agreement or participation account agreement, where the parties have a right on the results (profits and losses) for one or more operations of a business.

Tax-free corporate reorganizations

Merger

In Venezuela, mergers are governed by the Commercial Code, which stipulates that the surviving entity assumes the rights and obligations of the dissolving companies in the merger process.

A merger is a legal operation consisting of an agreement between two or more legally independent companies to combine operations into a single entity. Venezuelan law provides for two types of mergers:

— merger by absorption, which occurs when two or more companies merge into a single, previously existing company

— two or more companies merge to establish a new company that did not exist at the time the merger took place.

The tax law establishes that any benefits and liabilities should carry over to the surviving company. The surviving company inherits the target company's existing rights and obligations, as well as future obligations and responsibilities that may arise after the merger, as determined by the relevant authorities.

The target company's tax losses may be used to offset any outstanding tax obligations that exist on the day of the merger. These losses also may be carried forward for offset against the future taxable income of the acquiring corporation within 3 tax periods after the period in which the loss occurred, but the attribution may not exceed 25 percent of the enrichment achieved in subsequent periods.

A merger by absorption interrupts the current fiscal year and begins a new fiscal year for the combined operations of the merging companies. The absorbed company ceases its operations, and the surviving company incorporates into its equity the respective capital of the merged company.

The merged company must file its income tax return for the last year in which it performed individual operations within 3 months immediately following the cessation of its activities.

For tax purposes, in a merger by absorption, the fixed assets and liabilities of the merged company maintain their tax cost basis (i.e. tax basis carryover), including revaluation for inflation for entities subject to the inflation adjustment system. Such assets and liabilities may be restated for inflation at the first fiscal year-end following the date on which the merger took place. Non-monetary items are adjusted for inflation from the date of the merger.

As a result of this treatment, there are no major consequences from the fiscal inflation adjustment of fixed assets because they would have the same date of acquisition, historical costs and fiscal adjusted values held in the books of the merged company.

Other taxes

Real estate transfer taxes are due and payable by the transferring company on the transfer of assets from the target company to the acquiring company. Normally, on the registration of purchase-sale documents for real property and any other events, a 1 percent fee on the value of the property must be paid.

In the case of a sale of real property to a third party, the 1 percent income tax payment applies in addition to a 0.5 percent withholding prepayment, in either cash or credit, for income tax assessed on the sale price. This prepayment is credited to the income tax liability for the final income tax return of the year.

Demerger

Venezuelan tax law does not provide for a tax-free separation of a business, commonly referred to as a demerger.

Other considerations

When structuring a transaction, Venezuela's extensive network of tax treaties and investment protection treaties should be taken into account.

Concerns of the seller

A seller may be subject to tax when selling Venezuelan assets or shares. Where the seller is domiciled in a foreign country with a tax treaty with Venezuela, the sale of shares is unlikely to be taxable in Venezuela (depending on the type of company). However, a sale of assets or trading fund is taxable for the seller. For entities subject to the inflation adjustment system, the tax basis can be inflation-adjusted to reduce any taxable gain on asset disposals.

Depending on the type of assets sold, VAT may apply.

Disposals of shares and trading funds are subject to income tax withholding. VAT withholding may apply on the sale of goods.

Municipal tax could be assessed on gross income from the sale of goods. In some municipalities, the sale of a trading fund is deemed to be an extraordinary transaction and thus not subject to municipal tax.

Company law and accounting

A Venezuelan entity must prepare its financial statements according to Venezuela GAAP to determine its taxable income and the profit base for dividend distribution. The company by-laws would be included in the incorporation document.

Group relief/consolidation

Venezuelan legislation does not provide for affiliated companies to be taxed on their income as a group. All companies are taxed separately.

Transfer pricing

Venezuela's Income Tax Law and the Organization for Economic Co-operation and Development (OECD) transfer pricing guidelines both adopt the arm's length principle as

the standard for evaluating international intergroup pricing. Transactions comply with the arm's length principle where conditions imposed are comparable to those imposed by independent enterprises dealing with comparable transactions in comparable circumstances.

The pricing methods allowed by the tax law are:

— comparable uncontrolled price method

— re-sale price method

— cost plus method

— profit split method

— transactional net margin method.

Foreign investments of a local target company

Venezuelan taxpayers who have investments in a low-tax jurisdiction are subject to the transparency tax regime.

Income from foreign investment is subject to tax in Venezuela according to the worldwide tax regime. Tax treaty dispositions applied by a Venezuelan taxpayer could result in no or limited taxation in the country of source. The foreign tax credit system allows Venezuelan taxpayers to avoid or minimize double taxation by crediting foreign tax paid.

Transparency tax regime

Venezuela has enacted a look-through provision that imputes income arising from an entity residing or located in a country with a privileged tax regime (a tax haven) to a Venezuelan resident (individual or company) that directly or indirectly controls the foreign company. The tax haven entity's income is imputed to the Venezuelan owner even where such income is not distributed. Accordingly, the tax haven entity is considered a pass-through entity since its income, computed under the Venezuelan tax law rules, is attributed to the Venezuelan owner.

An entity is not subject to the transparency regime where:

— It carries on industrial or commercial activity in the country where it is located, measured by the proportion of fixed assets held by the entity (50 percent asset test).

— Its income does not represent a significant source of passive income (20 percent income test).

The Venezuelan Tax Administration maintains a blacklist of tax haven countries.

Value added tax

The VAT law stipulates that sales of tangible goods, including any part of their property rights as well as withdrawals or retirements of movable goods by taxpayers, are subject to VAT. However, VAT does not apply to sales of intangible goods, such as fiscal rights, stocks, bonds, mortgage bonds, mercantile effects and other securities, or to personal goods in general that represent money, credit or rights other than property rights over tangible goods.

VAT is applicable to property transferred to the merging company unless the surviving company carries on with the same purpose or activities that the dissolving company pursued, wholly or partially. In this case, there is no deemed transfer of ownership of corporate goods attributable to a sale for VAT purposes.

The surviving company may use the target company's VAT credits. VAT credits arise from the acquisition of goods and services. VAT debits arise from the sale of goods and services, and credits and debits are offset on a monthly basis. Excess credits are carried forward.

The sale of a trading fund may not be subject to VAT, except for the tangible goods involved in the sale. No VAT applies on the sale of a trading fund that may be considered a transfer of intangible good(s).

Large financial transaction tax

The Law on Large Financial Transactions establishes a tax of 0.75 percent on financial transactions, as of February 1, 2016. The tax applies to the financial transactions of special tax contributors that have been classified as corporate entities by the Venezuelan Tax Administration.

The tax applies to special tax contributors on financial transactions including:

— debits to bank, correspondent or escrow accounts, or any other type of demand deposit, liquid funds, trust assets, money market funds or any other financial instruments held at banks or any other financial institutions

— payment or cancellation of debts outside of the financial system

— debits to accounts for cross-border payments.

Banks and financial institutions acting as collecting agents are required to pay the tax daily. The tax is also required to be reported and paid by taxpayers when it is generated outside of the financial system.

Comparison of asset and share purchases

Advantages of asset purchase

— Depreciation/amortization of the price paid for the transferred assets (including acquired goodwill) is deductible.

— Possibility of acquiring only part of a business.

— A transfer of assets not comprising a going concern (trading fund) is not subject to tax withholdings.

Disadvantages of asset purchase

— Where the assets involve a transfer of a going concern (trading fund), the buyer's liability is limited up to the value of the transferred assets and, for up to 1 year after the Venezuela tax administration is notified of the sale, for tax debts owed by the seller in open previous years.

— Possible need to renegotiate supply, employment and technology agreements.

— Asset purchase may be unattractive to the seller, thereby increasing the price.

— Transactions involving real estate property are subject to proportional registration tax levied on the current value.

— Benefit of any losses and tax benefits incurred by the target company remains with the seller.

— VAT is levied on the transfer of movable goods.

— A transfer of assets comprising a going concern (trading fund) is subject to tax withholdings.

Advantages of share purchase

— Likely to be more attractive to the seller.

— VAT is not levied on the transfer of shares.

— May benefit from tax losses of target company after reorganization.

— May gain benefit of existing supply or technology contracts.

— Sale or transfer of shares held by residents of a country with a tax treaty in force with Venezuela usually does not trigger a tax obligation in Venezuela.

Disadvantages of share purchase

— Liable for any claims or previous liabilities of the entity relating to fiscal years still open to assessment.

— No deduction for the purchase price.

— Share acquisitions are subject to tax withholdings.

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Austria

Introduction

The Austrian tax environment for mergers and acquisitions (M&A) changed significantly in 2005, when Austria implemented an attractive new tax group system and reduced its corporate income tax rate to 25 percent. However, several new tax provisions have been implemented during the last years that affect M&As.

This report addresses the most important questions that arise with acquisitions in Austria:

— What should be acquired: the target's shares or its assets?

— What acquisition vehicle should be used?

— How should the acquisition vehicle be financed?

Tax is, of course, only one piece of transaction structuring. Company law governs the legal form of a transaction, and accounting issues are highly relevant when selecting the optimal structure. These areas are outside the scope of this report, but some of the key points that arise when planning an M&A transaction are summarized.

Asset purchase or share purchase

Large acquisitions in Austria usually take the form of a purchase of the shares of a company, rather than of its business and assets, because capital gains on the sale of shares may be exempt for the seller (if the seller is a foreign company and a tax treaty following the Organisation for Economic Co-operation and Development's (OECD) model treaty is applicable). Even though an asset deal usually remains more attractive for the buyer, the introduction of the tax group system in 2005 has increased the relative attractiveness of share deals for the buyer. However, the abolition of goodwill depreciation for transactions after 28 February 2014 has made asset deals more attractive once again.

Purchase of assets

The main tax effects of an asset deal consist of a new cost basis of the purchased assets (step-up) for the buyer, and a capital gain (in the amount by which the purchase price exceeds the cost of the asset) realized by the seller. According to Austrian tax law, the purchase or transfer of a participation in a partnership qualifies as an asset deal.

An asset deal should provide the buyer with the opportunity to buy only the assets actually desired and to leave unwanted assets, especially unwanted risks, behind. For this reason, an asset deal may be preferable if the target corporation has potential liabilities or, for example, owns real property. However, the real estate transfer tax (RETT) cost should be considered.

Capital gains from the sale of business property are subject to corporate income tax of 25 percent.

Purchase price

The purchase price must be allocated to all identifiable assets of the acquiring operation. Each identifiable asset is accounted for at its fair market value on the basis of which the depreciation or amortization is computed (potential step-up). Any portion of the purchase price that cannot be assigned must be accounted for as goodwill.

Goodwill

Goodwill purchased from a third party must be amortized over 15 years for tax purposes.

Depreciation

Depreciation of other assets charged in the accounts is generally accepted for tax purposes. Austrian tax legislation enables the cost of certain assets to be written off against taxable profits at a specified rate by means of capital allowances. Allowances are available for certain tangible assets (e.g. industrial and agricultural buildings) and intangible assets (except self-created intangible assets).

Before 2016, the annual rate of tax write-off for industrial and agricultural buildings, as well as buildings for banks and insurance companies, was 3 percent on a straight-line basis, provided that a minimum of 80 percent of the building was used for business operations. If less than 80 percent were

so used, the depreciation rate decreased to 2 percent for industrial and agricultural buildings and to 2.5 percent for banks and insurance companies.

As of 2016, the annual rate of tax write-off for buildings is basically 2.5 percent on a straight-line basis. For buildings used for residential purposes, the tax write-off amounts to 1.5 percent. In both cases, it is possible to obtain a higher write-off percentage where a corresponding expert report can be provided confirming that the actual useful life is shorter than the legal depreciation period.

Tax attributes

Tax losses are not transferred on an asset acquisition. They remain with the company or are extinguished. However, each identifiable asset has to be accounted for at its fair market value on the basis of which the depreciation is computed. Thus, the buyer has high depreciable amounts, which decrease the taxable base in the future. Any portion of the purchase price that cannot be assigned must be accounted for as goodwill. Goodwill purchased from a third party has to be amortized over a period of 15 years for tax purposes. A special regime applies for RETT levied on reorganizations.

Value added tax

Austria levies valued added tax (VAT) at a rate of 20 percent. For the transfer of certain assets, a reduced rate of 13 or 10 percent or tax exemptions may be available. For example, the transfer of shares is exempt from VAT. Certain reorganizations covered by the Reorganization Tax Act of 1992 (RTA) are deemed to be non-taxable for VAT purposes.

There are no specific rules for the transfer of a whole business. The VAT base is calculated based on the purchase price plus transferred liabilities, less tax-exempt or non-taxable items.

Transfer taxes

Stamp taxes on certain documents and transactions are levied when there are contracts or documents effecting the transaction from an Austrian stamp tax point of view. As of 2011, loan agreements and credit facilities do not trigger stamp tax. A contract relating to an asset deal as such is generally not subject to stamp tax, but the detailed written documentation regarding the transfer of certain assets and liabilities could trigger stamp tax. The liability for stamp tax can often be avoided by careful structuring of documentation.

Acquisitions of property located in Austria are subject to RETT. In general, the rate is 3.5 percent plus a 1.1 percent court registration fee of the purchase price.

Purchase of shares

Although the purchase price for shares usually reflects the fair value of the target's net assets (including goodwill), the purchase price has to be accounted for as the acquisition cost of the shares, so it is generally not depreciable.

As mentioned above, goodwill depreciation under the group taxation system was abolished for transactions effected after 28 February 2014.

According to the Austrian Income Tax Act and the Austrian Corporate Income Tax Act, the tax treatment of capital gains from the transfer of shares in a corporation depends on the seller's tax status.

— *Corporations:* Capital gains from the transfer of participations in Austrian corporations are taxable at the level of an Austrian corporate seller. For a foreign seller, treaty protection can often be obtained under an applicable double tax treaty. For participations in foreign corporations, the participation exemption provides for a tax exemption if certain conditions are met.

— *Individuals:* Capital gains from the disposal of shares qualify as taxable income. The tax rate was increased to 27.5 percent (from 25 percent), but it is possible to apply for the regular tax rate (from 0 to 55 percent).

Tax indemnities and warranties

In a share acquisition, the buyer is taking over the target company together with all related liabilities, including contingent liabilities. The buyer, therefore, normally requires more extensive indemnities and warranties than in the case of an asset acquisition.

Where significant sums are at issue, it is customary for the buyer to initiate a due diligence process, which would normally incorporate a review of the target's tax affairs. However, there are also transactions where the principle of caveat emptor (let the buyer beware) applies, and where warranties and indemnities would not be given.

Tax losses

Tax losses of the target company, in principle, transfer along with the company. A company's brought forward income-type losses (e.g. trading losses) cannot be offset against the profits of other companies through group relief, but they can be set off against the company's own future profits. The Austrian legislation provides a further restriction on the use of brought forward tax losses; their use can be partly or entirely denied by the tax authorities.

Loss carry forwards cannot be offset against future profits after an ownership change, if the so-called *Mantelkauf* provision applies. According to regulations in the Austrian Corporate Income Tax Act, the use of tax loss carry forwards by an Austrian company is denied if, from an overall point of view, the company is considered to have lost its identity. This is assumed in the case of:

— a substantial change in the economic and organizational structure

— a substantial change in the direct ownership of the company concerned.

This limitation does not apply if the changes mentioned earlier take place in the course of a reorganization that aims to maintain a workplace.

Losses carried forward can only be deducted against a maximum of 75 percent of current taxable income. Specific rules may apply within a tax group. Tax losses can be carried forward without time limitation ('evergreen losses').

Crystallization of tax charges

The buyer should obtain an appropriate indemnity from the seller that tax charges have been fully paid.

Transfer taxes

No stamp duty applies for the purchase of shares in an Austrian company.

As of 2016, the acquisition of 95 percent or more of all shares in a company ('pooling of shares') owning Austrian real estate is subject to RETT at a rate of 0.5 percent of the specific real estate value for RETT purposes (*Grundstückswert*) as of 2016. Shares pooled in the same Austrian tax group are accumulated for RETT purposes.

Before 2016, RETT of 3.5 percent was based on three times of a specific tax value (*Einheitswert*) and RETT was only applied if 100 percent of the shares in an Austrian company were acquired. RETT can often be avoided by careful structuring.

Choice of acquisition vehicle

There are several potential acquisition vehicles available to a foreign buyer, and tax factors often influence the choice. Capital tax on the introduction of new capital was abolished for 2016 and later years.

Local holding company

An Austrian holding company is typically used where the buyer wishes to ensure that tax relief for interest is available to offset the target's taxable profits or the taxable profits of other Austrian companies (or the Austrian permanent establishments of non-Austrian companies) already owned by the buyer.

In case of a share deal, the creation of a tax group can decrease the future taxable profit of the member companies.

The holding company can offset tax-deductible interest (see this report's information on deductibility of interest) against Austrian taxable profits of the target company in the combined post-acquisition group.

If the buyer is unable to form a tax group (because for example, only a minority share is acquired), interest is deductible at the holding company level (see 'Deductibility of interest'). However, if the deduction of the interest expenses results in a taxable loss of the holding company, this loss cannot be offset against Austrian taxable profits of the target company in lack of a tax group; it merely increases the tax loss carry forwards at the holding level.

For an asset deal, interest and borrowing expenses as well as goodwill depreciation are fully deductible at the level of the Austrian holding company without the creation of a tax group (However, see 'Deductibility of interest' below).

Foreign parent company

The foreign buyer may choose to make the acquisition itself, perhaps to shelter its own taxable profits with the financing costs. Dividend taxation and capital gains taxation on exit depend on the residency of the foreign buyer (the availability of treaty protection, its position regarding the dividend provisions of the European Union (EU) Parent-Subsidiary Directive, etc.). Thus, any intermediate holding company should have sufficient substance to cover its exposure in the event that a structure is challenged under the substance-over-form principle.

Further, the foreign company should be reviewed to ensure it does not qualify as Alternative Investment Fund, as this could have material adverse tax consequences.

Non-resident intermediate holding company

If the foreign country taxes capital gains and dividends received from overseas, an intermediate holding company resident in another territory could be used to defer this tax and perhaps take advantage of a more favorable tax treaty with Austria. However, the buyer should be aware that the Austrian authorities take a rather restrictive view on treaty shopping and thus the ability to structure a deal in a way designed solely to obtain tax benefits is restricted.

Local branch

A foreign buyer may structure the acquisition through an Austrian branch, as an alternative to the direct acquisition of the target's trade and assets. Austria does not impose additional taxes on branch profits remitted to an overseas head office. The branch would be subject to Austrian tax at the normal corporate rate, currently 25 percent. If the Austrian operation is expected to make losses initially, a branch might be advantageous since, subject to the tax treatment applicable in the head office's country, a timing benefit could arise from the ability to consolidate losses with the profits of the head office.

Joint venture

Joint ventures can be either incorporated (with the joint venture partners holding shares in an Austrian company) or unincorporated (usually an Austrian partnership). Partnerships are generally considered to provide greater flexibility from a tax viewpoint. For example, if the joint venture will incur initial losses, the partners should be able to use their shares of those losses against the profits of their existing Austrian businesses.

In practice, there may be non-tax reasons that lead a buyer to prefer a corporate joint venture. For example, a corporate body may enable the joint venture partners to limit their liability to the venture (assuming that lenders do not insist on

receiving guarantees from the partners). One fairly common structure involves the parties establishing a jointly owned Austrian company that borrows funds in order to acquire the Austrian target.

Choice of acquisition funding

A buyer using an Austrian acquisition vehicle to carry out an acquisition for cash will need to decide whether to fund the vehicle with debt, equity or a hybrid instrument that combines characteristics of both. The principles underlying these approaches are discussed below.

Debt

The principal advantage of debt is the potential tax-deductibility of interest, as the payment of a dividend does not give rise to a tax deduction. As of 2011, however, interest on loans taken out to acquire participations from related companies is no longer deductible for corporate income tax purposes. Further, as of March 2014, interest paid to a group-affiliated corporation is not tax-deductible if the beneficial owner is either low-taxed or subject to a tax-exemption on the interest income received (see deductibility of interest).

Another potential advantage of debt is the deductibility of expenses, such as guarantee fees or bank fees (this is only available for asset deals). These payments will be distributed over the term of the loan or credit. As of 13 June 2014, however, financial expenses on loans taken out to acquire participations are no longer tax-deductible.

Austrian legislation does not include any formal thin capitalization rules. In practice, a loan from an affiliated party is deemed to constitute hidden equity if it is granted in order to substitute the shareholder's equity. Thus, evidence has to be provided that a supply of equity would clearly not have been necessary at the time the loan was granted and that the loan is not a substitute for the required equity.

Moreover, the companies' capital ratio should be in line with commercial practice. A debt-to-equity ratio of 3:1 or even 4:1 should generally be sufficient, provided there are no unusual circumstances. To avoid a re-classification of the loan into hidden equity, documentation of the arm's length nature of the loan is required.

Deductibility of interest

Interest paid or accrued on debt is generally tax-deductible for the paying corporation, if the arm's length condition is met, the loan is properly documented and the company has a reasonable financing structure.

Interest on debt connected with an asset deal is deductible for tax purposes.

As of 2005, interest deduction has also been granted by law to share deals. As of 2011, in case of a share deal, interest on loans taken out to acquire participations from related companies is no longer deductible for corporate income tax purposes.

As noted earlier, as of March 2014, interest payments to group-affiliated corporations are no longer tax-deductible if the beneficial owner is considered to be low-taxed on the interest income received. Income interest is considered low-taxed if it is subject to:

— a nominal tax rate below 10 percent

— no taxation at all

— an effective taxation below 10 percent due to a special regulation, ruling or tax refund system.

An effective tax rate below 10 percent on interest due to loss compensations or losses carried forward does not trigger the non-deductibility of interest payments.

Payments to affiliated companies have to comply with the arm's length principle to be recognized for tax purposes. Interest payments to related parties may be classified as a hidden dividend to the extent that the consideration is not at arm's length or the underlying debt is classified as hidden equity. The tax authorities take a restrictive view of what constitutes an acceptable interest rate.

As a result of the upcoming transposition of the EU ATAD, the Austrian government is required to implement a general interest limitation rule. It is currently under discussion when the new limitation will be implemented.

Withholding tax on debt and methods to reduce or eliminate it

Austria does not levy any withholding tax (WHT) on interest on loans paid to a foreign company.

For non-resident companies, interest income is generally taxable only if the income is attributable to a permanent establishment in Austria. No WHT is levied on intercompany interest payments to non-resident companies.

Austrian tax law includes no thin capitalization rules. Payments of interest to an affiliated company that represent an amount that would not have been payable in the absence of the relationship are not deductible for Austrian tax purposes. In the case of a re-classification into hidden equity, WHT at a rate of 25 percent would be imposed on interest payments to foreign corporations under domestic law. This WHT can be reduced or eliminated under a tax treaty or the EU Parent-Subsidiary Directive.

Checklist for debt funding

— The use of bank debt avoids transfer pricing problems and the re-qualification of a loan into hidden equity.

— Consider whether the level of profits would be sufficient to absorb tax relief on interest payments.

— Consider whether a group-affiliated recipient (who also qualifies as the beneficial owner) is subject to taxation of less than 10 percent on interest income (see above).

— A tax deduction may be available at higher rates in other territories.

— No WHT applies on interest payments to non-Austrian entities.

Equity

A buyer may use equity to fund its acquisition or wish to capitalize the target post-acquisition.

As of 2016, no capital tax is levied on the injection of equity in Austria.

Under domestic law, there is no WHT on dividends paid by an Austrian company to another domestic corporation if the shareholding is at least 10 percent. If the EU Parent-Subsidiary Directive is applicable, no WHT applies on dividends paid to companies resident in the EU. Relief of WHT at source is available under certain conditions. A reduction of dividend WHT may also be available under a tax treaty. Dividends are not deductible for Austrian tax purposes.

While equity offers less flexibility should the parent subsequently wish to recover the funds it has injected, it may be more appropriate to use equity than debt in certain circumstances, such as:

— Where the target is loss-making, it may not be possible to obtain immediate tax relief for interest payments. Thus, the possibility of a re-classification of the loan into hidden equity would apply and the interest payments would be deemed to be dividends.

— Where the company is thinly capitalized, it would be disadvantageous to increase borrowings without also obtaining an injection of fresh equity. A tax-efficient structure normally requires a mix of debt and equity that provides adequate interest cover for Austrian tax purposes.

— There may be non-tax reasons for preferring equity. For example, in certain circumstances, it may be desirable for a company to have a low debt-to-equity ratio. This is one of the factors that have encouraged the use of hybrid funding instruments (see later in this report).

— The use of equity could also be more appropriate where participations are acquired from related companies as interests on loans of these acquisitions are no longer deductible (see deductibility of interest).

A recent change in Austrian tax law restricts the ability to choose whether to treat a dividend distribution as an equity repayment (not subject to WHT, reduction of tax book value) or profit distribution (basically subject to WHT). According to the new regulation, a profit distribution can only be effected to the extent it is covered by disposable internal financing. Before structuring a transaction, accumulated profits and released equity (both documented in the company's evidency account) should be considered.

Reorganizations

Austrian law includes a variety of special provisions that apply to mergers and acquisitions in areas ranging from corporate law, antitrust law and employment law to environmental law and tax law. Special tax treatment for M&As was introduced in the RTA. Since this law closely links the tax treatment of M&As to the legal structure chosen to effect a merger or acquisition, substantial thought needs to be given to the company law aspects of the proposed structure, as well as to its tax consequences under the RTA. Provided that certain conditions are met, a tax-neutral reorganization is often possible under the RTA.

Hybrids

Consideration may be given to hybrid financing — that is, instruments treated as equity for accounting purposes for one party and as debt (giving rise to tax-deductible interest) for the other. Various hybrid instruments and structures have been devised to achieve an interest deduction for the borrower with no income inclusion for the lender.

A regulation introduced in 2011 limits investments of Austrian companies abroad via hybrid instruments by denying a tax exemption for inbound dividends if the foreign distributing company is entitled to a deduction for the distribution.

Specialist advice should be obtained if such financing techniques are contemplated or already in place. Further, the restriction on interest payments to low-taxed affiliates (see above), effective as of March 2014, should be considered.

Extended anti-hybrid rules will soon be introduced in accordance with EU ATAD 1 and 2.

Discounted securities

The tax treatment of securities issued at a discount to third parties normally follows the accounting treatment.

Deferred settlement

An acquisition often involves an element of deferred consideration, the amount of which can only be determined at a later date on the basis of the business's post-acquisition performance. As a general rule, the overall purchase price, including discounted estimated earn-out payments, has to be capitalized at the level of the buyer. According to a court decision, a higher earn-out payment increases the overall purchase price. Otherwise, a lower earn-out payment should decrease the purchase price, but this is currently a gray area. Specialist advice should be sought on whether subsequent changes of the valuation should be treated as profit and loss (P&L) neutral or P&L-effective.

Earn-out clauses should be considered carefully, especially in the context of a reorganization.

Other considerations

Concerns of the seller

The tax position of the seller can be expected to have a significant influence on any transaction. In certain circumstances, the seller may prefer to realize part of the value of their investment as income by means of a pre-sale dividend. The rationale here is that the dividend may be subject to no or only a low effective rate of Austrian tax but reduces the proceeds of sale and thus the gain on the sale. However, the position of the Austrian authorities has become ever more restrictive in this respect (e.g. statements in the CIT guidelines) and should be reviewed carefully.

Company law and accounting

In general, under the earlier mentioned Austrian law, an acquisition can be structured as either a share or an asset purchase. If a share purchase is chosen, significant tax benefits can be achieved by subsequently establishing a tax group. Eventually, it may prove useful to effect further stages of reorganization after the acquisition to achieve a favorable tax result. Company law provides the vehicles needed to reach the most advantageous tax results.

Taxpayers are usually bound by the form they choose for a transaction. However, the government may challenge the tax characterization of the transaction on the grounds that it does not clearly reflect the substance of the transaction. Thus, the way parties choose to structure a transaction may have substantial tax consequences. In any event, it is highly recommended that acquisition structuring issues are discussed in good time and the parties properly record the intended tax treatment of the transaction in the documents associated with the transaction.

Group relief/consolidation

As of 2005, the old system of the Austrian tax unit (*Organschaft*) has been replaced by the new group taxation system enabling the pooling (no consolidation) of tax P&L of Austrian-resident group companies and joint taxation of national and international corporations. It is possible to use the tax losses of foreign subsidiaries directly held by Austrian group companies. However, these losses are, among other things, subject to a clawback at the time the foreign subsidiary earns profits against which the foreign loss carry forward can be offset.

Generally, the following conditions are required for the formation of a tax group:

— a participation of more than 50 percent

— majority of voting rights

— maintenance of the tax group for at least 3 years

— filing of a separate application for group taxation with the competent tax office (a tax unit under the old tax unit scheme will not be automatically replaced by the group taxation system).

Basically, all unlimited taxable corporations in Austria may act either as a parent company or as a group member under the group taxation system. A foreign company subject to limited tax liability in Austria that is comparable to an EU corporation (listed in the appendix of the Austrian Income Tax Act) may act as a parent company or a group member (if it is registered in Austria with a branch and the participation in the corporation can be allocated to the branch).

The participation of over 50 percent in group members may either be held directly or indirectly (via a partnership) or, in addition to a small direct participation, via another group corporation.

It is possible for mere holding companies to act both as group parent or group member. To avoid the risk of a challenge to the grouping, it is advisable for a holding company acting as a group parent to have minimal substance.

Before 2011, interest expenses arising from a leveraged share acquisition in a future group company were automatically deductible against the profits of the target business without the need for any complex restructuring. As of 2011, interest on loans taken out to acquire participations from related companies is no longer deductible for corporate income tax purposes. Further, the restriction on interest to low-taxed affiliates (see above) as of March 2014 should be considered.

P&L of Austrian group members will be pooled, resulting in final tax savings. As Austria does not have the right to tax the profits of foreign group members, only losses of foreign-resident group members need to be assigned to the parent company. This reduces the Austrian tax base, resulting in cash flow benefits for the group (although specific recapture rules should be considered).

However, according to draft legislation, the cross-border deduction of losses generated by foreign companies is limited to 75 percent of the profits earned in Austria. In addition, only foreign companies that are residents in another state with which a tax treaty providing a comprehensive assistance agreement ('major information clause') is in place can be included in an Austrian tax group (currently excluding, e.g. China).

Pre-group carry forwards of unlimited taxable group members may only be offset against the profits of the group company itself, not against profits of other group members, whereas tax loss carry forwards of the group parent can be offset against the group profit.

The general restriction that loss carry forwards can only be set off with 75 percent of future profits (surplus can be carried forward) is only applicable at the level of the parent company. At the level of each group member, pre-group tax loss carry forwards can be matched up to 100 percent with individually generated profits of the specific group member.

An impairment of a group member at the group-parent level during the life of the group will not be tax-effective and cannot be clawed back on termination of the group. In contrast,

participations in corporations not included in the tax group are still available for impairment of the participation under the general tax rules.

Transfer pricing

Austria implemented new rules for transfer pricing documentation in line with the OECD's final report on BEPS Action 13, with effect for business years starting 1 January 2016.

The Austrian Transfer Pricing Documentation Act (ATPDA) follows the three-tiered documentation approach by defining requirements to prepare a master file, local file and country-by-country-report. The ATPDA requires Austrian companies that are part of a multinational group to set up a master file and a local file if their sales exceed EUR50 million in the 2 preceding financial years. Country-by-country-reporting is required for multinational groups with a global consolidated group turnover of at least EUR750 million in the previous financial year.

In addition to the ATPDA, the OECD's transfer pricing guidelines are applied and transfer pricing documentation is reviewed in tax audits as a matter of routine.

In 2010, the Austrian tax authorities published Austrian transfer pricing guidelines, which require transactions involving foreign permanent establishments and foreign-affiliated parties as well as arrangements between related parties to comply with the arm's length principle.

In July 2017, a new edition of the OECD transfer pricing guidelines was published to reflect the transfer pricing-related revisions resulting from the BEPS project. Since the Austrian transfer pricing guidelines refer to the OECD guidelines, these updates also affect the guidance issued by the Austrian tax authorities.

Controlled foreign companies

Currently, the Austrian tax law has no specific regulations for taxing controlled foreign companies. Austria is obliged to introduce CFC rules in line with the EU ATAD by the end of 2018. As a result, the existing switch-over rules for dividend distributions will likely be amended or abolished. Draft legislation is expected to be published in the second quarter of 2018.

Dual residency

There are few advantages to using a dual resident company.

Foreign investments of a local target company

The shareholding of an Austrian corporation in a foreign company might qualify for the holding privilege if the minimum holding of at least 10 percent has been held for at least 1 year. Dividends are tax-exempt unless the switch-over provision (i.e. application of the credit instead of the exemption method for dividends received from low-taxed passive foreign companies) applies. In the year of the purchase of the participation (or the year the company holds a participation of 10 percent or more in the foreign company for the first time), the taxpayer has an irrevocable option to decide whether the participation is treated as tax-neutral or taxable.

If a tax-neutral participation qualifying for the holding privilege is sold, the capital gains are tax-free (capital losses are not tax-effective). Despite this, the Austrian holding privilege provides for a switch-over provision applicable in the case of low-taxed, passive subsidiaries. In this case, the tax exemption would change to a tax credit. Further, dividends are not tax-exempt if they are tax-deductible in the foreign country where the distributing company is resident.

If the option for a taxable participation is chosen, capital gains at the level of a corporation are taxable at the standard rate of 25 percent and capital losses can be claimed for tax purposes over a period of 7 years.

Comparison of asset and share purchases

Advantages of asset purchases

— The purchase price (or a proportion) can be depreciated or amortized for tax purposes.

— Interest payments connected with the acquisition are tax-deductible, provided the loan is not granted by a low-taxed affiliate.

— No undisclosed risks/liabilities of the company are inherited.

— No deferred tax liabilities on retained earnings.

— Possible to acquire only part of a company's business.

— Profitable operations can be absorbed by loss companies in the buyer's group, thereby effectively gaining the ability to use the losses.

Disadvantages of asset purchases

— Possible need to renegotiate supply, employment and technology agreements, and change stationery.

— Higher capital outlay is usually involved (unless the debts of the business are also assumed).

— Higher tax burden, especially if the seller is an individual, which may increase the purchase price.

— Accounting profits are reduced by the amortization of acquired goodwill.

— Any loss carry forwards remain with the seller.

Advantages of share purchases

— Likely to be more attractive to the seller (lower tax burden, especially for individuals), which can lead to a lower purchase price (compared with an asset deal).

— Tax loss carry forwards of the target company can be used in the future (subject to limitations).

— Existing supply or technology contracts may provide advantages.

— Real estate transfer tax (if land property is acquired) can be avoided under certain conditions.

— Interest deduction available unless a participation is acquired from an affiliated company or loan is granted by a low-taxed affiliate.

Disadvantages of share purchases

— Basically, no deduction of the purchase price compared to an asset deal.

— Deferred tax liability at the company level equal to the difference between fair value and tax book value of the net assets.

— Any prior undisclosed risks and liabilities remain with the target company and are acquired by the buyer, so warranties are recommended.

— No deduction of interest where a loan is taken out to acquire participations from related companies or granted by a low-taxed affiliate.

KPMG in Austria

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Belgium

Introduction

After implementing various European directives on corporate reorganizations, Belgium has developed a legal and tax framework for both cross-border and domestic mergers and acquisitions (M&A).

In a qualifying reorganization (merger, demerger and partial demerger, contribution of a universality of goods or a line of business), assets, liabilities and all related rights and obligations are in principle transferred automatically by law from the transferring company to the receiving company by the mere execution of the transaction in accordance with company law provisions. If the transaction qualifies for the tax-neutral regime, the transferor does not suffer any capital gains tax, while the receiving company gets no step-up in tax basis.

Both purely Belgian as well as cross-border reorganizations are eligible for tax neutrality. No tax-neutral treatment is available where the main or one of the main objectives of the transaction is tax evasion or tax avoidance. The concept of continuity, which applies from both legal and tax perspectives, also applies to the accounting treatment of the reorganization transactions.

When looking at acquisitions, an important issue is the absence of a fiscal unity in the Belgian income tax regime. A similar effect can often be obtained through a post-acquisition integration plan, which could include a merger of the target entity with the buying entity.

After an update on recent changes relevant to mergers and acquisitions (M&A), this report addresses the following fundamental decisions of a buyer from a Belgian tax perspective:

— acquisition through assets or shares

— choice of the acquisition vehicle

— funding of the acquisition vehicle.

This report focuses on the Belgian tax rules applicable to acquisitions and does not further elaborate on the Belgian tax treatment of mergers and similar transactions. The discussion focuses mainly on Belgian tax law. Company and accounting law are also highly relevant when dealing with both national and cross-border acquisitions. These areas are outside the scope of this report, but some of the key points are summarized later in this report.

Recent developments

On 29 December 2017, new legislation implementing a substantial corporate tax reform was published in the Belgian Official Gazette.

Entry into force is different for various measures, spanning from 2018 (assessment year 2019) to 2019 (assessment year 2020) to 2020 (assessment year 2021) and later years. The reform's primary objective was to reduce the corporate tax rate to 29.58 percent (including a crisis contribution of 2 percent) as of 2018 (assessment year 2019), and to 25 percent as of 2020 (assessment year 2021). Given that the tax reform has to be budgetary neutral, the legislation also includes compensatory measures.

The key additional measures relevant for the M&A practice in Belgium are as follows.

Measures in effect as of 2018 (assessment year 2019)

— *Minimum tax base*: A minimum tax base is introduced for companies with taxable profits over 1 million euros (EUR) by limiting certain deductions (e.g. tax losses), which are grouped in a 'basket'. To the extent taxable profits exceed EUR1 million EUR, only 70 percent of this basket is deductible.

— *Full participation exemption for dividends and capital gains on shares*: A dividend received by a Belgian corporate taxpayer is100 percent deductible (previously 95 percent) where certain quantitative and qualitative conditions are met. Subject to similar conditions, capital gains on shares are fully exempt. Existing participation requirements for dividends now also apply for capital gains: the taxpayer needs to hold a participation of at least 10 percent or the participation needs to have an acquisition value of at least EUR2.5 million. These new requirements have a negative tax impact for minority

participations, which may be relevant for management investment schemes.

— *Notional interest deduction*: This deduction is now calculated on the average qualifying increase of additional equity over 5 years (rather than on the full increase).

— *Requalification of capital reduction*: A reduction of capital is considered to be a pro rata reduction of capital and pro rata distribution of (taxed and in some cases untaxed) any available reserves. For reserves in this case, the dividend withholding tax (WHT; 30 percent standard rate) is due, where no exemption applies.

Measures in effect as of 2019 (assessment year 2020)

— *Tax consolidation*: As of financial year 2019 (assessment year 2020), Belgian corporate income tax law provides for a system of fiscal consolidation subject to strict conditions (i.e., 90 percent participation requirement, 5-year holding period, Belgian context).

— *Implementation of Anti-Tax Avoidance Directive*: The implementation of the European Union (EU) Anti-Tax Avoidance Directive (ATAD) will introduce controlled foreign company rules and measures preventing hybrid mismatches/branch mismatch arrangements.

Measures in effect as of 2020 (assessment year 2021)

— *Earnings-stripping rules*: As of 2020, the implementation of ATAD will limit the deduction of net interest incurred on loans to the greater of EUR3 million or 30 percent of earnings before interest, taxes, amortization and depreciation (EBITDA; consolidated Belgian base). The net interest that cannot be deducted because of the limit can be transferred to the following years without any time limitation. Exclusions apply.

Other recent developments

— In its judgment of 1 March 2018, the Belgian Constitutional Court cancelled the 'Fairness Tax', which is a separate tax on the distribution of dividends. However, the court upheld the consequences of the law for the assessment years 2014 to 2018 (in principle the financial years 2013 to 2017), except for the provisions that are in breach of the EU Parent-Subsidiary Directive on redistributed dividends.

Asset purchase or share purchase

From a buyer's point of view, an asset deal may be favorable, because it may allow the buyer to recover a significant part of the cost of the acquisition through depreciation of certain assets acquired at a relatively high corporate tax rate (currently 29.58 percent in Belgium). Under Belgian tax law, depreciable assets can include goodwill as well as other intangible elements.

Inherent goodwill acquired when shares are purchased is not tax-deductible for the buyer, nor are future reductions in the value of shares or capital losses incurred on disposal of the shares. The only exception is a capital loss a corporate shareholder incurs following the liquidation of a company in which it owns shares. Such loss is only deductible to the extent that the liquidation distributions made by the subsidiary are lower than the subsidiary's fiscal paid-in capital.

From a Belgian seller's perspective, a sale of shares generally is the preferred option because capital gains realized on shares are generally tax-free or low-taxed for Belgian individuals and companies. Where the seller is a Belgian company, there are certain exclusions from the favorable tax treatment for capital gains on shares (e.g. for shareholdings in tax-privileged companies). Also, as noted, a minimum holding period of 1 year applies as well as a minimum participation requirement (i.e. participation of at least 10 percent or with an acquisition value of at least EUR2.5 million).

For individuals, Belgian tax law provides that a capital gains tax (at a rate of approximately 18 percent) may be due in certain cases (substantial participation), where the buyer of the shares is a company resident in another member state of the European Economic Area (EEA). Further, the disposal of shares by Belgian individuals is taxable as miscellaneous income at a tax rate of approximately 35 percent where the transaction can be considered realized outside the management of the private estate. This may be particularly relevant in management buy-out structures.

In Belgium, most acquisitions take the form of a share deal, which allows the seller to avoid an upfront tax cost on capital gains and the buyer to recover the tax cost through tax-depreciation over several years.

Purchase of assets

A purchase of assets usually results in an increase in the base cost of those assets for both capital gains tax and depreciation purposes. In principle, this increase is taxable to the seller.

In an asset deal, shortly before the closing of the asset transfer agreement, the seller should request a certificate stating that the selling entity has no outstanding tax liabilities from the Belgian corporate income tax, value added tax (VAT) and social security tax authorities. The buyer must notify the Belgian authorities of the asset transfer agreement. These formalities are necessary for the asset deal to be recognized by the Belgian tax authorities and to avoid the joint liability of the buyer for unpaid taxes of the seller. If the asset purchase agreement is properly structured and the required notifications are lodged, no historical tax liabilities of the seller should transfer to the buyer in an asset deal. However, joint liability rules may apply where assets are transferred under legal continuity (an optional legal feature that is significant where a number of important contracts need to be transferred in the asset deal).

Purchase price

The assets should be acquired and recorded at fair market value. The excess paid over the book value in the hands of the seller must be allocated to specific assets. If that is not possible, the assets must be recorded as goodwill in the books of the buyer. Depending on the purchase price paid, the asset purchase thus results in a step-up in tax basis for depreciation purposes.

A corporate seller is taxable at the normal corporate tax rate of 29.58 percent (25 percent as of 2020) on any capital gain realized on the sale of assets, and tax deferral is possible where certain conditions are met (but not for own built-up goodwill). An individual seller is subject to tax at progressive tax rates on the professional assets sold. The seller generally can use tax losses or other available tax attributes to shelter the capital gain.

Goodwill

For tax purposes, goodwill must be depreciated over a minimum of 5 years. However, in most cases, the Belgian tax authorities argue that the depreciation period should be 10 to 12 years, and it is up to the taxpayer to demonstrate that the economic lifetime of the goodwill concerned is shorter.

Depreciation

Under Belgian tax law, depreciation of business assets is calculated on the basis of the acquisition cost over the useful life of the assets.

Until the financial year 2020 (assessment year 2021), both straight-line and declining-balance depreciation methods are accepted. As of 2020, the declining-balance method will be abolished.

Intangible fixed assets, cars and tangible assets that are depreciated by the owner but for which the right to use has been transferred must be depreciated on a straight-line basis. When using the declining-balance method, the taxpayer is allowed to switch back to straight-line when the depreciation computed by applying the declining-balance method is lower than the amount indicated by the straight-line method.

Apart from intangible fixed assets, which must generally be depreciated over a minimum of 5 years using the straight-line method, the tax law does not provide for any specific periods and rates. For certain assets, indicative rates are set by administrative instructions (e.g. 5 percent for industrial buildings).

Tax attributes

Tax loss carry forwards that were available to the company from which assets are acquired and current-year losses of that company are not transferred to the acquiring company. The same restrictions apply to any carry forward of notional interest deduction (NID) and investment deduction.

Generally, the seller can use those tax attributes to shelter the capital gain arising on the sale of assets.

Value added tax

The sale of assets of a business, except land and buildings, by a VAT payer is, in principle, subject to VAT. If a building is new within the meaning of the VAT code, the taxpayer has the option to elect to bring the sale of the building within the charge to VAT. Certain sales of new buildings are always subject to VAT.

Sellers may need to revise (partially repay) the VAT that they originally deducted on certain assets.

The transfer of a separate activity capable of separate operation — a transfer of a going concern — is not subject to VAT if the recipient is or, becomes as a result of the transfer, a VAT taxpayer.

Transfer taxes

Where Belgian real estate is involved in a purchase of assets, a real estate transfer tax is due (12.5 percent or 10 percent depending on the location of the real estate) on the market value of the real estate. For the transfer of real estate lease agreements, a 0.2 percent transfer tax is due. The rate is 2 percent for the transfer of leasehold rights. If the acquired assets do not include real estate, no transfer tax or stamp duty is levied.

Purchase of shares

On an acquisition of shares, no (separate) expression of goodwill is possible and depreciation and capital allowances are not allowed for tax purposes. In accounting, a write-down in value is required where the actual value of the participation is lower due to a long-term deterioration of the financial or economic situation of the underlying company. However, these write-downs are not tax-deductible.

On the seller's side, the capital gains realized on the shares are generally tax-exempt for individuals as well as for corporate sellers. As noted earlier, the favorable tax treatment for corporate taxpayers is subject to a minimum holding period of 1 year and a minimum participation of 10 percent or an acquisition value of at least EUR2.5 million.

Tax indemnities and warranties

In a share acquisition, the buyer takes over the target company, together with all related liabilities, including contingent liabilities. The buyer therefore generally needs more extensive indemnities and warranties from the seller in a share deal than in an asset acquisition. If significant sums are at issue, the buyer usually initiates a due diligence exercise, which normally incorporates a review of the target's tax affairs. To the extent possible, the findings of the due diligence investigation should be reflected in tax representations, warranties and indemnities in the share-purchase agreement. Typically, in a Belgian context, indemnifications are structured

as a reduction of the share-purchase price so that they are not taxable to the recipient.

Tax attributes

In principle, prior years' tax losses are available for set-off without time limitation. As noted, however, as of 2018, the government introduced a minimum tax base for companies with a taxable profit that exceeds EUR1 million by limiting certain deductions, grouped in a 'basket'. These deductions are only deductible from 70 percent of the taxable profit exceeding EUR1 million.

Further, following the introduction of certain measures intended to counter reorganizations or acquisitions that merely seek to use a company's tax losses, a change in control may limit the carried forward tax losses of the companies involved. Generally, previous tax losses of a Belgian company may not be deducted from future profits in the case of a change in control of that company, unless the change of control is for sound business, financial or economic reasons. This rule applies equally to a direct change of control and an indirect change of control further up the shareholder's chain.

The same rule applies to any carry forward of NID, investment deduction and unutilized dividends received deduction.

The burden of proof lies with the taxpayer. The Belgian tax authorities generally take the position that the financial or economic reasons for the transaction need to be assessed in the context of the company subject to the change of control. Among other things, financial and economic reasons are deemed to exist where, following the change of control, the company continues to operate in the same business with all or some of its employees.

Crystallization of tax charges

Given that fiscal consolidation is not yet allowed and taking into account the specific characteristics of the new regime entering into force as of 2019 (see 'Debt' below), no tax charges related to previous intragroup transfers should crystallize in the target on acquisition of the shares of the target company.

Transfer taxes

No stamp duty is due on the transfer of shares. A share deal should not give rise to real estate transfer tax.

Choice of acquisition vehicle

Several possible acquisition vehicles are available to a foreign buyer, and tax factors generally influence the choice. There is no proportionate capital duty on the introduction of new capital into a Belgian company or branch. In a Belgian context, the strict conditions to benefit from the system of tax consolidation need to be considered when determining the transaction structure.

Local holding company

Except for the current absence of a fiscal consolidation regime, Belgium generally has favorable rules for the deductibility of interest expenses and transaction costs incurred on an acquisition of shares.

An advantage of using a Belgian company as an acquisition vehicle is, for example, that Belgian tax law currently has favorable thin capitalization rules. With the introduction of a 5:1 debt-to-equity ratio for intragroup financing, the deductibility of interest expenses is restricted but still leaves a broad margin for debt financing. As of 2020, the earnings-stripping rule imposed by the European ATAD will enter into force, limiting the deductibility of interest expenses to the higher of EUR3 million or 30 percent of EBITDA.

At the time of the sale of the shares in the target company by the Belgian company, capital gains realized are tax-exempt where the shares qualify for the dividend received deduction (i.e. Belgian participation exemption regime, generally requiring that the target is subject to a normal tax regime). As indicated, a 1-year minimum holding period applies for capital gains on shares as well as a minimum participation requirement (i.e. participation of 10 percent or with an acquisition value of at least EUR2.5 million).

The acquisition by a Belgian company is particularly attractive where the buyer already has a taxable presence in Belgium. In this case, the existing tax capacity could be used to shelter the acquisition costs and interest expenses.

A capital increase into a Belgian holding company is subject to a flat registration tax of 50 euros (EUR). The sale of shares is not subject to stamp duty.

Foreign parent company

A foreign parent company could be considered where the interest expenses from the acquisition financing can be offset against taxable profits of the foreign company.

In addition to the exemptions on the basis of the EU Parent-Subsidiary and Interest and Royalty Directives, Belgium also has an extensive tax treaty network that significantly reduces or eliminates WHT on interest payments and dividends to a foreign parent.

For Belgian individuals, Belgian tax law provides that a capital gains tax (at a rate of about 18 percent) may be due on the sale of (or part of) a substantial participation in a Belgian company to a non-Belgian legal entity located outside the EEA. A 'substantial participation' generally is defined as the ownership (alone or with relatives) of more than 25 percent of a Belgian company in the current or preceding 5 years. Only participations in Belgian-based companies trigger this taxation.

The transfer of shares to a foreign buyer is not subject to stamp duty.

Non-resident intermediate holding company

If the country of a foreign buyer taxes capital gains and dividends received from a Belgian target, an intermediate holding company resident in another territory could be used

to defer this tax and perhaps take advantage of a more favorable tax treaty with Belgium. Generally, neither Belgian domestic rules nor the Belgian tax treaties currently include severe beneficial ownership restrictions. However, sufficient substance is required to claim benefits under treaties or the EU directives.

Local branch

As an alternative to the direct acquisition of the target's assets, a foreign buyer may structure the acquisition through a Belgian branch. For income tax purposes, a branch is not subject to additional tax duties and is taxed at the standard corporate tax rate of 29.58 percent (25 percent as of 2020). No WHT applies on profit repatriations from the branch to the foreign head office (however, see 'Fairness tax on dividend distributions'). Where the Belgian operation is expected to make losses initially, a branch may be advantageous since, subject to the tax treatment applicable in the head office's country, a timing benefit could arise from the ability to consolidate losses with the profits of the head office.

The sale of or withdrawal of assets from a branch triggers a tax liability on any capital gains, apart from capital gains on shares, which generally benefit from favorable tax treatment, as noted previously.

Joint ventures

Under Belgian tax law, joint ventures are generally structured as corporate vehicles, and no specific tax rules apply to them. Under Belgian company law, possibilities to structure joint ventures as unincorporated partnerships are limited.

Choice of acquisition funding

A buyer using a Belgian acquisition vehicle for an acquisition for cash needs to decide whether to finance the transaction with debt, equity or a hybrid instrument that combines the characteristics of both.

Debt

Financing an acquisition with debt has the traditional advantage that the interest cost and other expenses (e.g. bank fees and other transaction costs) may be tax-deductible. Belgium's new system of fiscal consolidation as of financial year 2019 (assessment year 2020) may facilitate the offset of interest expenses on acquisition financing at the level of a Belgian acquisition vehicle against operating income of the target company, after a certain period of time. However, taking into account the strict conditions that must be met to benefit from this fiscal consolidation regime (i.e. only available from the 5th taxable period after the acquisition; see 'Group relief/consolidation'), alternative debt pushdown mechanisms may be required, such as the following:

— *Equity reduction*: One way to obtain a (partial) debt pushdown is to replace the distributable reserves (and share capital) of the target company with debt (equity stripping). However, the Belgian tax authorities are on the lookout to challenge the interest-deductibility for such transactions, backed by some first negative court decisions for taxpayers. In the view of KPMG in Belgium, the court decisions have been rather poorly motivated, giving taxpayers important arguments to defend the deductibility of interest expenses incurred in relation to an equity reduction within the context of a M&A transaction.

— *New activities*: To use the interest charges on the acquisition financing, taxable income could be created at the level of the acquisition vehicle, for example, by transferring activities or developing new activities, which may include management services. Potential exit taxes should be taken into account.

— *Merger*: A debt pushdown through merger could be organized, although the Belgian tax authorities would likely deny the tax-neutral status of a merger of a pure holding company (acquisition vehicle) and its operational subsidiary, triggering a tax cost on all hidden capital gains (including goodwill) at the level of the operating company. A legal merger may be feasible in the case of an acquisition by a Belgian operating entity.

Deductibility of interest

Generally, interest incurred to acquire shares should be tax-deductible in principle. However, some restrictions need to be taken into account.

Currently, a 5:1 debt-to-equity ratio applies for intercompany debt. Certain other limitations apply to the tax-deductibility of interest payments in specific situations. Finally, as of 2020, an earnings-stripping rule will be introduced.

Thin capitalization rules

Under the 5:1 debt-to-equity rule, interest is not deductible where:

— the recipient is resident in a tax haven or is a company belonging to the same group, and

— the total amount of related loans is more than 5 times the aggregate of the company's taxed reserves (at the beginning of the accounting year) and paid-up capital (at the end of the accounting year).

This 5:1 debt-to-equity ratio replaced a 7:1 ratio that only applied to beneficial owners in a tax haven. For the application of the new debt-to-equity rule, a group is considered to be an entirety of affiliated companies that fall under the same management or controlling company that directly or indirectly holds 20 percent of a company belonging to the group.

In order to assess whether a company belongs to a group, the participations in this company held by all other group companies are added.

Interest payments on loans granted by finance and credit institutions generally fall outside the scope of this thin 5:1 capitalization rule.

Further, the 5:1 thin cap rule for intercompany loans (not for loans from tax havens) will be replaced by an earnings-stripping rule as of 2020 (see below).

Under a separate 1:1 debt-to-equity rule, interest on loans from shareholders (individuals) and directors (individuals or foreign [non-EU; cf. European Court of Justice (ECJ) case law] corporations) is re-characterized as a (non-deductible) dividend where:

— the interest rate exceeds the market rate

— the total amount of loans is higher than the company's paid-in capital at the end of the accounting year, increased by its taxed reserves at the beginning of the accounting year.

Earnings-stripping rules

Following the implementation of the EU ATAD, as of financial year 2020 (assessment year 2021), the deduction of net interest incurred on loans will be limited to EUR3 million or 30 percent of EBITDA, whichever is greater. The net interest that cannot be deducted because of the limit can be transferred to later years indefinitely. This new rule should be considered on the basis of the Belgian consolidated tax position (ad hoc consolidation).

Other limitations

Generally, interest payments are not tax-deductible where they exceed the market interest rate for the type of loan concerned, taking into account the particular circumstances of the loan. This limitation does not apply to interest paid to Belgian banks, financial institutions or their branches, or to interest paid on publicly issued bonds.

Interest paid directly or indirectly to a tax-privileged non-resident taxpayer (whether or not affiliated) or to a tax-privileged foreign branch is tax-deductible only where the paying company can demonstrate that the payments are for bona fide purposes and that the interest paid does not exceed an arm's length interest rate.

A general disclosure obligation applies for payments to tax havens if certain thresholds are exceeded.

Withholding tax on debt and methods to reduce or eliminate it

In principle, under Belgian domestic law, as of 1 January 2017, interest paid by a Belgian company is subject to a 30 percent WHT (previously 27 percent).

Important exemptions from interest WHT include:

— interest paid to a Belgian-resident company

— interest on registered bonds subscribed by a non-tax-privileged foreign investor

— interest paid by Belgian enterprises (including Belgian companies and Belgian permanent establishments of foreign companies) to financial institutions established in an EEA member state or tax treaty state.

A specific WHT exemption applies to interest paid by Belgian taxpayers qualifying as a (listed) holding company or 'financial enterprise' (essentially defined as an intragroup bank; see below) on loans from non-resident lenders.

For purposes of this exemption, a 'holding company' is defined as a Belgian company or a Belgian branch of a foreign company:

— that owns shares that qualify as financial fixed assets that have an acquisition value of at least 50 percent, on average, of the total assets on its balance sheet at the end of the taxable period before the attribution or payment of the interest

— the shares of which are listed on a recognized stock exchange, or at least 50 percent are held, directly or indirectly, by a listed company that is subject to corporate income tax, or to a similar foreign income tax regime, and that does not benefit from a special tax regime or from a tax regime that is considerably more favorable than that in Belgium.

A 'financial enterprise' is defined as a Belgian company or a Belgian branch of a foreign company that:

— belongs to a 'group of related or associated companies' as defined by company law

— carries out its activities exclusively for the benefit of group companies

— engages exclusively or predominantly in services of a financial nature

— seeks external funding exclusively with resident or non-resident companies with the sole purpose of financing its own activities or those of group companies

— owns no shares with an acquisition value that exceeds 10 percent of the financial enterprise's net fiscal value.

Further, Belgium has opted for a flexible implementation of the EU Interest and Royalties Directive. From a Belgian perspective, the debtor and the beneficiary of the interest (or royalties) are associated companies where, at the moment of attribution or payment, one of the companies has had a direct or indirect holding of at least 25 percent in the capital of the other company for an uninterrupted period of at least 1 year, or both companies have a common shareholder established in the EU that has had a direct or indirect holding of at least 25 percent in the capital of both companies for an uninterrupted period of at least 1 year. In principle, interest and royalties paid between 'associated companies' (as defined earlier) are exempt from WHT. The Belgian government has extended the scope of the exemption beyond those mentioned in the directive to all companies resident in Belgium.

Checklist for debt funding

— The use of bank debts may avoid transfer pricing problems and should facilitate the interest deduction as long as interest payments are at arm's length. Within a 5:1 debt-to-equity ratio, interest on intragroup loans generally is tax-deductible (subject to certain other specific restrictions and entry into force of the new earnings-stripping rule).

— In principle, interest payments are subject to a WHT of 30 percent, but various exemptions or reductions are available.

— Taking into account the strict conditions to be fulfilled to benefit from the system of fiscal unity entering into force as of 2019, the actual tax savings for interest payments on acquisition financing still depend on the amount of taxable income available at the level of a Belgian acquiring company. As noted earlier, various debt pushdown mechanisms are available.

Equity

If an acquisition is funded with equity, dividend payments to the parent company are not deductible for Belgian tax purposes (unlike interest payments).

However, in some situations, funding with equity may allow for the deduction of notional interest. The benefit of the Belgian NID regime on equity has significantly reduced since its introduction.

Notional interest deduction

When considering funding a Belgian entity with equity or debt, the impact of the NID should be taken into account.

This measure was intended to encourage the strengthening of companies' equity capital by reducing a tax advantage for funding with loan capital, as opposed to equity capital.

Initially, the NID was based on the full equity (after some adjustments) of resident and non-resident corporate taxpayers. As of assessment year 2019 (calendar year 2018 for companies with an accounting year that follows the calendar year), the NID will be calculated on the incremental equity of the year (capital increases + retained earnings) and no longer on total equity. Further, in order to temper fluctuations, the NID will be calculated on the average increase of the equity over a period of 5 years.

Further, within the context of M&A, when calculating the equity qualifying for the NID, the company's equity (among other things) is reduced by the net fiscal value of the company's own shares and of shares and participations in other companies that are part of the company's financial fixed assets or qualify for the dividends received deduction. As a result, no NID is generally available for an acquisition vehicle.

The rate of the NID is determined each year and is linked to 10-year government bonds, subject to certain caps. The NID rate is 0.237 percent for assessment year 2018 (financial year 2017) and 0.746 percent for assessment year 2019 (financial year 2020).

Initially, if a company's taxable base was not sufficient to use the entire NID, the balance could be carried forward for up to 7 years. The ability to carry forward unutilized NID has been abolished. The carry forward of NID existing at the time of the abolition remains available for carry forward under restrictions.

Withholding tax on equity and methods to reduce or eliminate it

Under Belgian domestic law, dividends paid by a Belgian company are currently subject to a 30 percent WHT. As of 7 July 2013, small companies may benefit from a 15 percent WHT on dividends (subject to certain conditions).

An exemption from dividend WHT is available for dividends paid by a Belgian subsidiary to its parent company, provided the parent company is a Belgian company or a qualifying resident company of another EU member state that has or will hold at least 10 percent (minimum shareholding as of January 2009) of the shares in the Belgian subsidiary for an uninterrupted period of at least 1 year.

Finally, a general exemption from WHT was introduced for dividend payments to companies located in a tax treaty country made under conditions similar to those set out in the EU Parent-Subsidiary Directive (provided that the tax treaty (or any other treaty) provides for the exchange of information in fiscal matters).

Fairness tax on dividend distributions

On 18 July 2013, a fairness tax was introduced for dividends distributed by a Belgian company (not applicable to qualifying small and medium-sized enterprises).

The fairness tax applies in addition to and separately from the corporate income tax. Like corporate income tax, the fairness tax is not deductible. No deductions or compensation of the loss of the taxable period can be made to the taxable base for fairness tax purposes.

The fairness tax rate is 5.15 percent (5 percent plus a 3 percent crisis surcharge). The fairness tax is levied for the taxable period for which dividends are distributed, and the tax is determined on the basis of a specific calculation. The fairness tax entered into force as of assessment year 2014 (generally financial year 2013).

Belgian branches of foreign companies may also be subject to the fairness tax.

On 28 January 2015, the Belgian Constitutional Court decided to ask three prejudicial questions to the ECJ to verify whether the fairness tax is in line with the EU Freedom of Establishment and Parent-Subsidiary Directives. According to ECJ, the fairness tax is partially contrary to EU law because the fairness tax breaches article 4 of the Parent-Subsidiary

Directive. In addition, the ECJ left it to the Constitutional Court to decide whether the fairness tax constitutes an infringement of the freedom of establishment.

In its judgment of 1 March 2018, the Constitutional Court cancelled the fairness tax but upheld the consequences of the law for the assessment years 2014 to 2018 (in principle, financial years 2013 to 2017), except for the provisions that are in breach of the EU Parent-Subsidiary Directive on redistributed dividends. In practice, the fairness tax can be applied on dividends distributed for assessment years 2014 to 2018. Nevertheless, 'redistributed' dividends that are in scope of the EU Parent-Subsidiary Directive should be excluded from the taxable basis of the fairness tax.

Equity reorganizations

According to Belgian tax law, the following conditions must be met for a domestic reorganization (mergers, [partial] divisions or demergers and contributions of a line of business or of a universality of goods) to take place under a tax-neutral regime:

— The absorbing company must be a resident of Belgium or another EU member state (EU Merger Directive requirements must be met).

— The reorganization must be performed in accordance with the merger provisions of Belgian and foreign company law.

— The reorganization must not have as its principal objective, or as one of its principal objectives, tax evasion or tax avoidance.

The tax-neutral framework is thus available both for domestic reorganizations as well as for cross-border reorganizations within the scope of the EU Merger Directive.

Discounted securities

Under Belgian tax law, there are no specific tax rules for securities acquired at a discount. Specific tax rules may apply to non-interest-bearing receivables or receivables with an interest rate below the market rate.

Deferred settlement

If properly structured, future additional payments for the acquisition of a target company on the basis of its future profits (earn-out clauses) can usually qualify as part of the purchase price of the shares. In principle, this additional purchase price benefits from favorable tax treatment to the seller and increases the share purchase price (non-tax-deductible) to the buyer.

Other considerations

Company law and accounting

Previously, Belgian companies were not entitled to give advances, grant loans or provide securities to third parties to enable the latter to acquire their own shares (prohibition of financial assistance). Recently, this restriction was removed and replaced by an entitlement, as a matter of principle, for companies to provide financial assistance with a view to the acquisition of their shares by a third party. This financial assistance is subject to strict conditions:

— The operation must take place under the responsibility of management and under fair and equitable market conditions.

— The operation requires the prior consent of the general meeting.

— Management must draw up a report indicating the reasons for the proposed transaction, the interest for the company, the conditions under which the transaction will take place, the risks inherent in the transaction to the company's liquidity and solvency and the consideration for which the third party will acquire the shares.

— The sums used under the operation must be available for distribution (net asset test); the company must book, on the passive side of the balance sheet, a non-distributable reserve equal to the amounts used for the financial assistance.

— Where a third party acquires shares that have been subject to financial assistance or subscribes to a capital increase, such acquisition or subscription must take place at a fair price.

— Belgian company law provides certain other exceptions to the prohibition of financial assistance without the strict conditions noted above (e.g. for employee takeovers).

There are no specific issues relating to acquisitions from a Belgian accounting perspective.

Group relief/consolidation

As of financial year 2019 (assessment year 2020), Belgian corporate income tax law will provide for a system of fiscal consolidation, allowing for a shift of taxable profit through a 'group contribution' (for tax but not accounting purposes). To benefit, a 90 percent participation will be required and both the payer and beneficiary must be resident of the EEA and subject to tax in Belgium. In addition, the 90 percent participation must be held for an uninterrupted period of 5 taxable years. As a result, the first post-acquisition group contribution between the acquiring company and the acquired company will only be possible from the 5th taxable period after the take-over.

An indirect technique to obtain tax consolidation involves the use of tax-transparent partnerships. Here, care must be taken to ensure the tax authorities have no reason to impute abnormal profit-shifting to either a foreign group entity or Belgian loss-making company. For foreign group entities, the profit shifted abroad is added back to the taxable income of the transferring company; for Belgian loss-making companies, the Belgian beneficiary is not permitted to offset its brought forward and current-year losses against the abnormal income received.

Abnormal profit shifting can be deemed to exist not only in the absence of adequate compensation for the transferor but also where a transaction is carried out in economically abnormal conditions. Where a profit-generating activity is transferred to a loss-making related company (e.g. through a tax-neutral contribution of a separate activity) in order to obtain an indirect tax consolidation, the tax authorities might deny the loss-making company the right to offset its brought forward losses against the profits from the activity transferred.

In some cases, where a Belgian target company has accumulated losses, an indirect corporate tax consolidation can be achieved through the waiver or forgiveness of a debt claim on the loss-making company. A common technique in Belgium is a conditional waiver of a debt claim, where the loan is reinstated if the debtor's financial position improves. Close attention should be paid to such waivers because the Belgian tax authorities scrutinize the business motivation closely.

The concept of VAT-unity was introduced in Belgian law, but specific rules apply where a Belgian target company is extracted from an existing fiscal unity as a result of an acquisition.

Transfer pricing

After an acquisition, where an intercompany relationship develops between the buyer company or group and the target, due care needs to be taken to ensure all such transactions are at arm's length. Failure to comply with the arm's length principle may give rise to transfer pricing problems. In a Belgian context, both abnormal and benevolent advantages received or granted could give rise to adverse tax consequences.

An advantage is generally considered by the tax authorities as abnormal or benevolent where the receiving party enriches itself without adequate or real compensation. Belgian case law has defined the notion of 'abnormal or benevolent advantage' as follows:

— abnormal is anything that is contrary to the normal practice in a similar situation

— benevolent implies the idea of a gift without (sufficient) compensation.

Where a Belgian enterprise grants an abnormal or benevolent advantage, the amount of the advantage is added back to the taxable base of the enterprise concerned unless the advantage is taken into account when determining the taxable base of the recipient of the advantage (article 26, Belgian Income Tax Code — BITC). In principle, where the recipient is a Belgian company, the tax authorities accept that this anti-abuse provision does not apply. This should also be the case where the recipient is in a tax loss position.

According to article 207 BITC, tax losses and certain other tax attributes (e.g. investment deduction, NID) cannot be set off against income from so-called abnormal or benevolent advantages received from enterprises that are directly or indirectly related to the company receiving the benefit. The Belgian company receiving the abnormal or benevolent advantage cannot offset prior- or current-year tax losses or other tax attributes from the (implied) profit corresponding to the received advantage. The Belgian tax authorities' position is that this results in the advantage being immediately taxed in the hands of the company receiving the advantage (cash-out), irrespective of prior- or current-year tax losses or other available tax attributes. The minimum taxable basis of a Belgian company thus includes the total amount of abnormal or benevolent advantages received. In the case of such adjustment, the tax loss carry forward is increased and the advantage is effectively subject to tax. Thus, the overall effect generally would be a timing difference (deferral of use oftax losses).

Dual residency

In Belgium, no specific rules apply to dual resident companies. In general, a company is considered a Belgian company for tax purposes if its place of effective management is in Belgium.

Foreign investments of a local target company

In principle, profits realized through a foreign branch are tax-exempt at the level of the Belgian target company under an applicable tax treaty. If no tax treaty is available, the branch profits (net of any foreign income taxes) are taxable at the ordinary Belgian corporate income tax rates.

Foreign branch losses generally are tax-deductible from the profits of the Belgian target company. However, the Belgian company is subject to recapture rules where branch losses are deducted from foreign branch profits.

Finally, Belgian tax law currently does not impose controlled foreign company or similar rules. Such rules will enter into force as of 2019 (assessment year 2020). Belgium has adhered to the transactional approach, with the aim of tackling artificial arrangements with the primary purpose of obtaining a tax benefit.

Comparison of asset and share purchases

Advantages of asset purchases

— The purchase price (including goodwill) may be depreciated/amortized for tax purposes.

— In general, no previous (tax) liabilities of the seller are inherited.

— The buyer assumes no inherent tax liabilities on tax-exempt or hidden reserves.

— Possible to acquire only part of a business or some valuable assets ('cherry-picking').

— Automatic consolidation of profits or losses of the acquiring entity (including transaction costs and interest charges) with profits or losses of the business acquired.

Disadvantages of asset purchases

— Possible need to renegotiate certain business-related agreements (e.g. supply agreements, renewal of licenses). In principle, the option to subject the asset deal to the system of legal continuity results in a transfer of all applicable agreements by force of law (subject to exclusions).

— Where only assets are acquired, a higher capital outlay is usually involved (unless the liabilities of the business are also assumed).

— Usually unattractive to the seller (due to tax charges on capital gains resulting from an asset deal), thereby increasing the price.

— Real estate transferred is subject to a 10 or 12.5 percent registration duty (unless the transfer is within the VAT regime) and must comply with environmental legislation. Also, a real estate transfer may trigger a VAT revision.

— Accounting profits may be affected by the creation and authorization of acquisition goodwill.

— The potential benefit of any pre-acquisition tax losses or other tax attributes remains with the seller.

Advantages of share purchase

— Only net assets are purchased, so the capital outlay is lower.

— More attractive to the seller because capital gains on shares may be tax-exempt.

— Carried forward tax losses and other tax attributes of the target company generally remain unaffected if there are business reasons for the change in control.

— Buyer may gain the potential benefit of existing business agreements (subject to any change in control clauses).

— No registration duties and VAT revisions apply on the transfer of shares (unless anti-avoidance provisions apply).

— No environmental formalities are required on a transfer of real estate as part of a share purchase.

Disadvantages of share purchases

— Buyer acquires inherent tax liabilities on tax-exempt reserves and hidden reserves.

— Previous (tax) liabilities of the company are inherited.

— The purchase price or any goodwill included in the purchase price cannot be depreciated for tax purposes. This is generally compensated by a lower purchase price.

— Strict conditions need to be met to benefit from the system of tax consolidation (as of 2019), and specific debt pushdown mechanisms will likely still be required.

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Bosnia and Herzegovina

Introduction

Bosnia and Herzegovina (BiH) is administratively divided into two major entities: the Federation of Bosnia and Herzegovina (FBiH) and the Republic of Srpska (RS). Indirect taxes are regulated nationally at the level of BiH, and direct taxes are regulated at the level of entities. This results in a complex tax environment with different rules and requirements in each entity.

Despite this complexity, BiH generally has been an attractive market for foreign investors, resulting in a number of successful mergers and acquisition (M&A) projects.

In recent years, however, M&A activity has decreased, due in part to the worsening global financial climate and also to the lack of official guidance and practice regarding BiH's complex taxation system.

This report provides general information on M&A provisions in BiH that have been in place since 2016 in both the RS and the FBiH.

Despite the number of mergers and acquisitions that took place in BiH in recent years, the BiH tax system is still relatively immature. A number of structuring options available in other jurisdictions are not used in BiH, so KPMG in Bosnia and Herzegovina cannot comment on them.

Recent developments

New corporate profit tax (CPT) laws were adopted in 2015 and 2016 in the RS and the FBiH respectively, both applicable as of 2016. The RS CPT law was also amended in 2017.

The main provisions of CPT laws in both the FBiH and the RS are summarized in the following paragraphs.

Mergers and acquisitions

Federation of Bosnia and Herzegovina

Based on the FBiH CPT law, where there is a continuance in taxation (i.e. the successor continues to be a taxpayer), a merger is CPT-neutral. Continuance in taxation is deemed to exist where assets and liabilities are transferred from predecessor to successor at their book values.

Rights and liabilities of a predecessor are transferred to a successor. The predecessor is obliged to submit its financial statements and final CPT return up to the merger date.

Republic of Srpska

Based on the RS CPT Law, where there is a continuance in taxation (i.e. the successor continues to be a taxpayer), a merger is CPT-neutral. Continuance in taxation is deemed to exist where assets and liabilities are transferred from predecessor to successor at their book values.

Rights and liabilities of a predecessor are transferred to a successor. The predecessor is obliged to submit its financial statements and final CPT return up to the merger date.

Incentives

Federation of Bosnia and Herzegovina

Tax incentives relevant for M&A transactions in the FBiH include the following:

— 30 percent CPT incentive in the year of investment, when the taxpayer invests 50 percent of profit from its own funds from a tax period in production equipment (excluding passenger vehicles)

— 50 percent CPT incentive in the years of investment for a 5-year period where the taxpayer invests 20 million Bosnian convertible marks (BAM; approximately 10 million euros — EUR) from its own funds in fixed assets used for production activities (excluding residential units and passenger vehicles). BAM4 million (approximately EUR2 million) must be invested in the first year.

The taxpayer is authorized to use only one of the above incentives during 1 tax period.

Taxpayers lose the incentives set out above where:

— they make a dividend payment from the profits covered by the incentive within 3 years after the last year in which the tax incentives were used

— they do not meet the investment requirements during the 5-year period as required

— they use the right to transfer tax losses within 2 years after the last year in which the tax incentives were used.

In the event of loss of incentives as set out above, the taxpayer is obliged to pay the difference in CPT as though no incentives existed, together with late interest.

Another FBiH tax incentive is the right to a tax-deductible expense that amounts to double the amount of paid gross salaries to newly employed employees where:

— the duration of employment is at least full-time for 12 months

— the new employee has not been employed by the taxpayer or a related party within the last 5 years.

Republic of Srpska

Tax incentives for M&A transactions in the RS include a 30 percent CPT incentive in the year of investment, when the taxpayer invests 50 percent of profit from its own funds from a tax period in equipment, facilities and real estate used for the purposes of conducting registered business manufacturing activities, provided the equipment, facilities and real estate are not sold within 3 years from the day that the equipment, facilities and real estate are put into use. If the taxpayer sells or otherwise disposes of the equipment, facilities and real estate within the 3-year period, it must repay the amount of reduced tax on this basis, with interest.

Withholding tax

Federation of Bosnia and Herzegovina

Withholding tax (WHT) applies to certain payments made to non-resident legal entities. These payments include:

— dividends

— specified interest payments

— payments for intellectual property rights, management, technical and educational services (including market research, tax advisory, consulting and audit services)

— payments for lease of movable and immovable property

— payment for entertainment and sports events

— insurance premiums for insurance or reinsurance of risks in FBiH

— payments for telecommunication services

— payments for other services to non-residents with which BiH does not have a signed tax treaty.

The standard WHT rate is 10 percent, while a rate of 5 percent applies to dividend payments.

The WHT rate may be decreased or eliminated pursuant to an effective tax treaty.

Income that a non-resident receives from a resident or a non-resident in FBiH, on the basis of sale or transfer with compensation for real estate, stocks or shares in capital that are considered as long-term financial placements and industrial property rights, is considered as taxable income of the non-resident, unless regulated differently in an applicable tax treaty.

The non-resident is obliged to report this income and make an appropriate payment of tax independently or via a representative to the tax administration office in the municipality where the real estate is located or where the company whose shares are being sold is registered, within 30 days of receiving the income. If the non-resident does not file a tax report and make the payment within the 30 days, then the tax should be paid by the buyer of the real estate or the resident whose shares are being transferred.

Republic of Srpska

WHT applies to certain payments made to non-resident legal entities, including:

— dividends

— specified interest payments

— payments for intellectual property rights, music, entertainment, art or sports programs

— payments for professional, scientific, technical and educational services (e.g. market research, advertising and promotion)

— payments for management, consulting, tax advisory, business advisory, accounting, legal and audit services

— insurance premiums

— payments for telecommunication services

— lease of movable property.

The standard WHT rate is 10 percent.

The WHT rate may be decreased or eliminated pursuant to an effective tax treaty.

Asset purchase or share purchase

Purchase of assets

Federation of Bosnia and Herzegovina

In accordance with the FBiH CPT law, capital gains determined in the balance sheet are added to the CPT base. Capital gains are defined as all amounts that directly increase accumulated and current profits in the balance sheet, disclosed in line with International Accounting Standards (IAS) and/or International Financial Reporting Standards (IFRS).

The historical tax liabilities generally remain with the company; that is, a taxpayer undergoing a change of status is obliged to submit its financial statements and CPT returns with a closing date a day before the date of the merger.

Republic of Srpska

Generally, in accordance with the RS CPT law, capital gains/losses increase/decrease the tax base. Capital gains are defined as an increase in transaction value of assets from the moment of their purchase to the moment of their disposal.

Goodwill

Federation of Bosnia and Herzegovina

The tax treatment of goodwill follows the IFRS treatment; goodwill is subject to the impairment test and not to annual amortization.

Republic of Srpska

In accordance with RS CPT Law, goodwill is not subject to annual amortization.

Depreciation

Federation of Bosnia and Herzegovina

Depreciation of assets is generally recognized for tax purposes up to the amounts and under the conditions prescribed by the CPT law.

Republic of Srpska

Depreciation of assets is generally recognized for tax purposes up to the amounts and under the conditions prescribed by the CPT law and a rule book on depreciation of fixed assets for tax purposes in the RS.

Value added tax

Value added tax (VAT) in BiH is levied at the state level and generally complies with the European Union (EU) VAT Directive.

The standard VAT rate is 17 percent. Exports of goods are VAT-exempt (with the right to recover input VAT; i.e. taxable at 0 percent).

Generally, the transfer of a part of a taxpayer's property is considered as a sale of goods for consideration, subject to VAT, whereas input VAT is fully or partially deductible at the time the property is purchased, manufactured or otherwise acquired.

The transfer of a business as a going concern, however, is outside the scope of VAT, provided certain conditions are met.

Transfer taxes

Transfers of land and buildings may be subject to real estate transfer tax, which is levied at the level of FBiH's 10 cantons.

Real estate transfer tax in the RS was abolished as of 1 January 2012, and a property tax was introduced. The property tax rate varies from 0 to 0.20 percent (0.10 percent for real estate in which production activities are undertaken) of the total asset value, depending on the municipality/city.

Purchase of shares

The purchase of a target company's shares does not result in an increase in the base cost of that company's underlying assets; there is no deduction for the difference between underlying net asset values and consideration.

Tax losses

Tax losses are not transferred on an asset acquisition. They generally remain with the company (for entities in both FBiH and RS).

In principle, in an acquisition of shares, carried forward tax losses previously generated by a target company remain with a company.

In both FBiH and RS, tax losses incurred in 1 tax year can be carried forward and deducted from a tax base for 5 consecutive years, after which the right to deduction expires.

Tax losses cannot be carried back.

Crystallization of tax charges

For both FBiH and RS, the statute of limitations for tax liabilities is generally 5 years, unless fraud is suspected.

It is not unusual for the buyer to obtain an appropriate indemnity from the seller for the statute of limitations.

Pre-sale dividend

Relevant legislation is not explicit in prescribing whether or not advance dividends are possible, and KPMG in BiH is not aware of any guidance from the tax authorities on the tax treatment of advance dividend. In practice, advance dividends are not common.

There are no explicit limitations on the payment of advance dividends, except that they are subject to final assessment of profits at year-end.

In other words, advance dividends should be recorded as receivables until the year-end assessment of profits, after which they are recorded as distributed profits. In the case of loss, the recipient of advance dividends is obliged to refund them or keep them as advance dividends for future periods.

Choice of acquisition vehicle

Local holding company

Dividends received in both FBiH and RS entities are not taxable (payments from resident to resident), but capital gains on sales of shares are subject to CPT.

Foreign parent company

Federation of Bosnia and Herzegovina

Traditionally, the most commonly used acquisition vehicle has been a foreign parent company.

However, WHT applies to dividends, interest and certain other payments paid to non-residents by an FBiH resident, subject to tax treaty relief.

Republic of Srpska

Traditionally, the most commonly used acquisition vehicle has been a foreign parent company.

WHT applies to dividends, interest and certain other payments paid to non-residents by an RS resident, subject to tax treaty relief.

Non-resident intermediate holding company

As with foreign parent companies, non-resident intermediate holding companies have traditionally been used.

Also, as with foreign parent companies, WHT applies to dividends and interest paid to a non-resident intermediate company, subject to tax treaty relief.

Local branch

Foreign legal entities can have local branch offices in the FBiH and the RS.

Joint venture

Although uncommon, joint ventures are usually corporate.

Choice of acquisition funding

Common methods of financing are debt and equity.

Debt

The main advantages of debt financing are general interest deductibility and greater flexibility, as no registration with the relevant court is required.

Deductibility of interest

In both the FBiH and the RS, the general transfer pricing rules (arm's length principle) apply. No maximum interest rate is prescribed for interest charged by a foreign related party to BiH.

There are no thin capitalization rules in the RS.

In the FBiH, financial expenses for interest per financial agreements and instruments to related parties are generally recognized for tax purposes. However, if the ratio of these obligations per financial agreements and the registered share capital of a taxpayer exceeds the ratio of 4:1, then the financial expenses exceeding the 4:1 are not tax recognizable and cannot be transferred to another tax period. However, this does not apply to banks and insurance companies.

Withholding tax on debt and methods to reduce or eliminate it

Payments of interest are subject to 10 percent WHT. Generally, a tax treaty may reduce or eliminate the rate of WHT.

Checklist for debt funding

There are no specific tax provisions that re-characterize debt funding as equity funding.

Equity

The use of equity generally offers less flexibility as any change in share capital must be registered with the relevant court. However, equity may have some non-tax advantages.

Also, equity is generally preferable where the target is loss-making and it is not possible to obtain immediate tax relief for interest payments.

Hybrids

Hybrids currently are not used in BiH.

Discounted securities

Although uncommon, the tax treatment of securities issued at a discount to third parties should normally follow the accounting treatment.

Deferred settlement

An acquisition sometimes involves an element of deferred consideration. The tax treatment of a right to receive an unknown amount in the future generally follows the accounting treatment.

Other considerations

Concerns of the seller

The tax position of the seller can be expected to significantly influence any transaction, so it is advisable to investigate tax implications before making any commitments.

Company law and accounting

Company laws applicable in the FBiH and the RS prescribe how companies may be formed, operated, reorganized and dissolved. For example, foreign legal entities can register a branch office in both the FBiH and the RS.

For entities in both the FBiH and the RS, the relevant laws prescribe that distribution of profit may be only made out of a company's distributable reserves.

From an accounting perspective, IFRS is fully applicable in BiH.

Group relief/consolidation

Tax grouping is generally allowed in the FBiH under certain conditions.

Transfer pricing

Where post-acquisition transactions between the parties involved are not at arm's length, transfer pricing issues may arise in the relevant jurisdictions.

Foreign investments of a local target company

There are no controlled foreign company rules in BiH.

Comparison of asset and share purchases

Advantages of asset purchases

— Possible to acquire only part of a business.

— Previous liabilities of the company are not inherited.

Disadvantages of asset purchases

— Benefits of any tax losses incurred by the target company generally remain with the seller.

— May give rise to VAT where not classified as a going concern.

— May give rise to irrecoverable transfer taxes (e.g. on land, vehicles).

Advantages of share purchases

— Buyer may benefit from tax losses of the target company.

— Likely more attractive to the seller, so the price may be lower.

Disadvantages of share purchases

— Buyer effectively becomes liable for any claims or previous liabilities of the entity.

Bosnia and Herzegovina — Withholding tax rates

This table sets out reduced WHT rates that may be available for various types of payments to non-residents under BiH's tax treaties. This table is based on information available up to 6 March 2018.

Source: Official Gazette of Bosnia and Herzegovina, Bosnia and Herzegovina Ministry of Finance and Treasury, 2018

	WHT rate (percent)		
	Interest[1]	Dividends	Royalties
Treaty with:			
Albania	10	5	10
Algeria	10	10	10
Austria	5	5	5
Azerbaijan	10	10	10
Belgium	10	10	10
China	10	10	10
Croatia	10	5	10
Cyprus	10	10	10
Czech Republic	N/A	5	10
Egypt	15	5	15
Finland	N/A	5	10
France	N/A	5	N/A
Germany	N/A	15	10
Greece	10	5	10
Hungary	N/A	10	10
Iran	10	10	15
Ireland	N/A	N/A	N/A
Italy	10	10	10
Jordan	10	5	10
Kuwait	5	5	10
Macedonia	10	5	10
Malaysia	10	5	8
Moldova	10	5	10
Montenegro[2]	10	5	10
Netherlands	N/A	5	10
Norway	N/A	15	10
Pakistan	20	10	15
Poland	10	5	10
Qatar	7	5	7
Romania	7,5	5	10
Serbia	10	5	10

	WHT rate (percent)		
	Interest[1]	Dividends	Royalties
Slovak Republic	N/A	5	10
Slovenia	7	5	5
Spain	7	5	7
Sri Lanka	10	12.5	10
Sweden	N/A	5	N/A
Turkey	10	5	10
United Arab Emirates	N/A	5	5
United Kingdom	10	5	10

Notes:

1 Some treaties provide for an exemption for certain types of interest, e.g. interest paid to the state, local authorities, the central bank or export credit institutions, or in relation to sales on credit. Such exemptions are not considered in this column.

2 Tax treaty concluded between Bosnia and Herzegovina and the former Serbia and Montenegro.

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Croatia

Introduction

This report addresses the three fundamental decisions facing a prospective buyer in Croatia:

— What should be acquired: the target's shares or its assets?

— What acquisition vehicle should be used?

— How should the acquisition vehicle be financed?

Tax is, of course, only one piece of the transaction structuring puzzle. Company law governs the legal form of a transaction. Accounting issues are also highly relevant when selecting the optimal structure. These areas are outside the scope of this report, but some key points that arise when planning the steps in a transaction are summarized later in this report.

Recent developments

Three recent developments impacting M&A are discussed in detail later in this chapter:

— the rules regarding the taxation of the transfer of real estate

— the ability to apply for binding tax opinions on the tax treatment of future and planned transactions, business events and activities

— the ability to use an arm's length interest rate for related-party loans.

Asset purchase or share purchase

The usual form of an acquisition in Croatia is the purchase of shares of a Croatian company rather than its assets. The purchase of assets is a less attractive option for a foreign seller of shares because capital gains on sales of assets of a Croatian company are taxable and there is a risk of double taxation on remittance of the sales proceeds.

Where the seller of the shares of a company is a Croatian tax non-resident or a Croatian tax resident individual, any capital gains may be exempt from taxation in Croatia. However, the acquisition of assets has certain advantages for the buyer. Both forms of acquisition are discussed below.

Purchase of assets

In the case of a purchase of assets, the agreed value is usually above book value and the buyer may use this increased cost base for capital gains tax and depreciation purposes. Historical tax liabilities generally remain with the seller and are not transferred with the purchased assets.

Purchase price

It is necessary to apportion the total consideration among the assets acquired. A purchase agreement should be concluded to specify the allocation, which is usually accepted for tax purposes provided it is commercially justifiable.

Goodwill

Generally, goodwill that arises in acquisitions is subject to annual impairment testing for accounting purposes. Any impairment of goodwill cannot be deducted for tax purposes under Croatian legislation.

Depreciation

For tax purposes, fixed assets are depreciated using the straight-line method of depreciation, using annual depreciation rates as follows:

— buildings and boats over 1,000 gross register tons — 5 percent

— personal cars — 20 percent

— intangible assets, equipment, vehicles and plant — 25 percent

— information technology equipment and mobile phones — 50 percent

— other long-term assets — 10 percent.

A taxpayer may elect to double these depreciation rates, in which case, the depreciation period is halved. Generally, no justification is required to apply double depreciation rates. However, if a taxpayer applies 'normal' depreciation rates and then decides to change its depreciation policy and apply double depreciation rates, the tax authorities might request an explanation for the change. The depreciation charge prescribed by the Corporate Profit Tax (CPT) Law can be claimed for tax purposes only where the same amounts were booked in the taxpayer's income statement.

Tax attributes

Tax losses are not transferred to the buyer on an asset acquisition. They remain with the seller or are eliminated.

Where the buyer wishes to acquire the seller company's trade along with its tax losses, a business activity may be transferred to a new company (typically through simultaneous demerger and merger) and the new company can then be sold to the buyer. However, transferred tax losses are only available to the buyer (i.e. merged company) where the activity test is satisfied as detailed in this report's section on tax losses.

Value added tax

Value added tax (VAT) is charged on most goods and services at the standard 25 percent rate. The transfer of shares is not subject to VAT. The transfer of assets is generally subject to VAT at the rate of 25 percent. Reduced rates of 13 percent and 5 percent apply to certain goods and services. The transfer of shares is not subject to VAT. The transfer of assets is generally subject to VAT at the rate of 25 percent. The transfer of a business as a going concern is not subject to VAT, provided certain conditions are met. To benefit from this exemption, the aim of the transfer must be to put the new owner in possession of a business unit. Therefore, the sale of a portion of assets cannot be classified as a transfer of a business unit: all assets and liabilities related to the business unit need to be transferred.

The transfer of land (except for construction sites), buildings and the land on which buildings stand are exempt from VAT. The exemption does not apply to a sale by a VAT-registered taxpayer before first occupation or if less than 2 years elapsed between the date of first occupation and the date of sale.

Transfer taxes

There are no stamp duty or stamp duty land tax requirements in Croatia.

Croatia levies transfer tax at the rate of 4 percent on transfers of real estate that is not considered to be 'new' which includes real estate in use for longer than 2 years.

In certain cases the parties may opt to have the transfer of such real estate taxed with VAT rather than transfer tax in cases where (if the buyer is VAT-registered and intends to use the real estate for making VAT-able supplies), with the view to eliminating the tax cost of supplies of real estate for business purposes.

In certain cases, the transfer of real estate as a contribution in kind to the share capital of a company eliminates transfer taxes and VAT.

As of 1 January 2018, the special 5 percent tax on the transfer of used personal motor vehicles and motorcycles was replaced by an administrative duty, payable based on the age of the vehicle and engine power (ranging from 1 to 50 Croatian Kuna (HRK) per kilowatt for personal motor vehicles and from HRK0.1 to 3 per cubic centimeter for motorcycles).

Purchase of shares

The purchase of shares as a form of acquisition does not result in an increased cost base of the underlying assets.

Tax indemnities and warranties

On a purchase of shares, the buyer takes over not only the company's assets but also its liabilities, including contingent liabilities. Thus, the buyer usually requires more extensive indemnities and warranties than in the case of an asset purchase. Where significant amounts are involved, the buyer customarily conducts a due diligence exercise, including a review of the target company's tax affairs.

Tax losses

Tax losses may be carried forward for a maximum of 5 years. Earlier losses are set off before later ones. Croatia has no loss carryback or tax grouping provisions.

The utilization of tax losses is restricted in the case of a corporate restructuring (activity test). A legal successor does not assume the right to carry forward the tax losses of a legal predecessor where either:

— the legal predecessor did not perform any business activity during the 2 taxation periods preceding the statutory change

— the legal successor significantly changes the type of business activity performed by the legal predecessor in the 2 taxation periods following the statutory change (except where the purpose of the change is to preserve a workplace or restructure the business).

Where the legal successor utilizes the tax losses and subsequently loses the rights for reasons mentioned above, the legal successor is obliged to increase its taxable base in the period in which the right to carry forward tax losses expired.

These provisions on the utilization of tax losses and increase of taxable base of a taxpayer also apply where there is a change in the taxpayer's ownership structure of more than 50 percent compared to the ownership structure at the beginning of a tax period.

Pre-sale dividend

It is possible for the seller to realize part of the consideration through a pre-sale dividend payment. The proceeds from the sale of shares are decreased as a result of the payment of the pre-sale dividend. Since dividend payments are currently not subject to taxation for Croatian corporate shareholders, a pre-sale dividend payment reduces tax liabilities on the gain on the sale of the shares that may arise for a Croatian corporate seller.

Tax clearances

It is possible to apply for binding tax opinions.

An advisory body for binding tax opinions (appointed by the director of the tax authorities) has the authority to issue binding tax opinions on the tax treatment of future and planned transactions, business events and activities. Such opinions are binding on the tax authorities. Generally, the deadline for the issuance of a binding tax opinion is 60 days

(90 days for more complicated opinions and longer periods in exceptional cases). The cost of obtaining a binding tax opinion for companies ranges from HRK5,000 to 30,000, depending on company income (income from HRK3 to 150 million). The cost of obtaining a binding opinion for individuals amounts to HRK5,000.

Areas of application for binding tax opinions are as follows:

— determining taxable supplies for the purpose of input VAT deduction pro-rata

— application of tax regulations regarding investment projects with a value in excess of HRK20 million

— determining the corporate profit tax base in the case of merger, de-merger, partial de-merger, transfer of assets and share-for-share exchange

— application of double tax treaties

— tax treatment of 'unusual' business activities.

The tax authorities' previous practice was to issue opinions on a taxpayer's request. Such opinions were not binding for the tax authorities or the taxpayer. Although it is still possible to apply for such non-binding opinions, with the introduction of the binding opinion concept, an additional level of certainty is available to taxpayers.

Further, in the course of tax inspections, prior to issuance of minutes of inspection, the tax authorities and the taxpayer can conclude a settlement for tax liabilities identified during the course of a tax inspection. One of the conditions required for entering into a settlement is that the taxpayer accepts the tax liabilities identified and waives the right to use legal remedies. If a settlement is concluded, penalty interest can be reduced by up to 100 percent (although it is not possible to reduce potential fines).

Choice of acquisition vehicle

There are several acquisition vehicles the buyer may choose, depending on the specifics of the acquisition. There is no capital duty on the introduction of new capital to a Croatian company.

Local holding company

Buyers do not prefer local holding companies as it may be difficult to offset the target's taxable profits with interest payments on funds borrowed by the Croatian holding company to purchase the target company. The reason is that, in the absence of tax-grouping provisions, the deduction for interest payments on borrowed funds generally can be achieved only through a subsequent merger of the Croatian holding company and the target company. Further analysis of the accounting and taxation implications of the merger is required to determine whether this is feasible.

Where the funds to purchase the target company are obtained cross-border, interest payments may be subject to certain limitations discussed in the sections on deductibility of interest and withholding tax (WHT) on debt below.

Foreign parent company

Where a foreign parent company wishes to offset the cost of financing the purchase of the target company against its own taxable profits, the target company may be purchased through the foreign parent company.

WHT of 12 percent applies to dividends paid by a Croatian company to foreign companies. The WHT rate may be decreased or eliminated under one of Croatia's tax treaties.

In addition, dividends paid to European Union (EU) resident companies or qualifying Swiss companies are exempt from Croatian WHT, provided certain conditions are met (see 'Equity' later in this chapter).

Non-resident intermediate holding company

The buyer may opt for a non-resident intermediary holding company as an acquisition vehicle where the foreign parent's country of residence taxes capital gains and/or dividends received from foreign companies. This structure potentially allows the buyer to take advantage of a more favorable tax treaty than the treaty its country of residence has concluded with Croatia.

Local branch

Interposing a Croatian branch between the buyer and the target would not achieve additional tax advantages because a branch is treated as a regular taxpayer for Croatian tax purposes. However, the head office of any branch office may be able to claim any tax losses, especially financing costs. This would need to be considered case-by-case.

Joint venture

It is possible to establish a partnership or contractual joint venture in Croatia. In either case, a local company or branch office must be established.

Choice of acquisition funding

A buyer that decides to pay for acquisition of a Croatian target via a Croatian company as the acquisition vehicle needs to decide whether to structure the acquisition as an asset purchase or share purchase and whether to obtain financing using debt or equity.

Debt

The principal advantage of debt is the potential tax-deductibility of interest (see this chapter's section on deductibility of interest), as the payment of a dividend does not give rise to a tax deduction. Another potential advantage of debt is the deductibility of expenses, such as guarantee fees and bank fees, in computing profits for tax purposes.

To minimize the tax cost of debt, there must be sufficient taxable profits in the company borrowing the funds to offset interest expenses. Dividend income received by a Croatian

company is not taxable, and there are no tax-grouping provisions. Therefore, the acquisition of a Croatian target company by a Croatian acquisition vehicle with financing costs but no taxable income is tax-inefficient.

Deductibility of interest

Croatian CPT law prescribes certain limitations on the tax-deductibility of expenses. Generally, in order to be deductible for CPT purposes, expenses need to be incurred with the purpose of generating income (i.e. profits). In addition, the deductibility of interest is subject to two specific limitations.

The first limitation arises from the thin capitalization rules that apply to non-resident shareholders that are not financial institutions. Interest on loans provided by direct non-resident shareholders with at least 25 percent of the shares or voting rights is not deductible for CPT purposes on the amount of the loan that exceeds four times the amount of the capital held by that shareholder. The thin capitalization rules also apply to loans guaranteed by a direct non-resident shareholder and to loans received from related parties.

The second limitation is that interest paid on loans provided by either resident related parties that are in a tax-favorable or tax loss position or by non-resident related parties is CPT-deductible, up to the interest rate prescribed by the Minister of Finance. If no interest rate is prescribed, the Croatian National Bank's discount rate is used. The interest rate prescribed by the Minister of Finance for Croatian CPT purposes on loans between related parties in 2018 is 4.55 percent per year.

In addition, as of 1 January 2017, instead of using the interest rate prescribed by the Minister of Finance, the interest rate in transactions with related parties can be determined by applying one of the transfer pricing methods. If one of these methods is applied, it must be consistently applied to all loans.

Parties are related where one of the parties directly or indirectly participates in the management, supervision or capital of the other, or where the same legal persons (one of which is a resident Croatian company and the other is a non-resident company) participate in the management, supervision or capital of another company.

Withholding tax on interest and methods to reduce or eliminate it

Interest payments made by Croatian-resident entities to any Croatian non-resident entities (whether or not related) are subject to Croatian WHT at the rate of 15 percent at the time of payment.

Exceptions are available for loans provided by foreign banks and financial institutions and interest paid on qualifying bonds issued by Croatian entities.

Further, where the foreign entity providing the loan is in a jurisdiction with which Croatia has a tax treaty and that foreign entity is the beneficial owner of the interest, the tax treaty may reduce or eliminate the WHT liability. To take advantage of a reduced rate, the prescribed form needs to be submitted to the tax authorities. To eliminate the WHT, the Croatian company needs to possess either a statement that the receiving entity is a tax resident of the treaty country or the prescribed form.

In addition, interest paid to EU-resident companies or qualifying Swiss companies is exempt from Croatian WHT where a minimum direct 25 percent shareholding exists between both companies or where a third company owns directly at least 25 percent of both companies, provided that the participation is held for an uninterrupted period of at least 2 years and certain other conditions are met.

Checklist for debt funding

— The use of cross-border bank debt as opposed to related party debt may avoid thin capitalization and transfer pricing issues and eliminate WHT.

— Tax losses from interest expenses can be carried forward for 5 years.

— Consider whether the level of taxable profits is sufficient to enable tax relief for interest payments.

— Establish whether a tax deduction may be available at higher rates in other territories.

— WHT of 15 percent may apply to interest payments to non-Croatian entities.

Equity

Croatia does not have any capital duty, and neither stamp duty nor stamp duty reserve tax applies to new share issues. Dividends payable to Croatian resident companies are not treated as taxable income for Croatian resident companies for Croatian tax purposes.

Dividend payments made by Croatian-resident companies to Croatian non-resident entities (whether or not related) are subject to Croatian WHT at the rate of 12 percent at the time of payment. Where the foreign entity shareholder resides in a jurisdiction with which Croatia has a tax treaty and that foreign entity is the beneficial owner of the dividend, the tax treaty may reduce or eliminate the WHT. To take advantage of a reduced rate, a prescribed form needs to be submitted to the tax authorities. If WHT is eliminated, the Croatian company needs to possess either a statement that the receiving entity is a tax-resident of the treaty country or the prescribed form.

In addition, dividends paid to EU resident companies or qualifying Swiss companies are exempt from Croatian WHT where the shareholder owns at least 10 percent (for Swiss shareholders, at least 25 percent) of the payer's shares, the shares have been held continuously for at least 2 years, and certain other conditions are met.

Although equity offers less flexibility should the parent subsequently wish to recover the funds it has injected, equity

may be more appropriate than debt in certain circumstances. For example:

— Where the target company is loss-making, it may not be possible to obtain immediate tax relief in the target for interest payments.

— Possible restrictions for tax relief for interest in the country of the borrower may eliminate the principal advantage of using debt.

— Where the target is thinly capitalized, it would be disadvantageous to increase the target's borrowings without also injecting fresh equity. A tax-efficient structure normally requires an appropriate mix of debt and equity so that debt-to-equity is adequate for Croatian tax purposes.

— There may be non-tax grounds for preferring equity, for example, where it is necessary or desirable for the target to have a low debt-to-equity ratio.

Mergers and demergers

Mergers and demergers should have no influence on taxation if continuity in taxation exists. Continuity in taxation is deemed to exist where, on merger or demerger, there is no change in the value of items of assets and liabilities that are being transferred. In addition, on a merger, the activity test must be satisfied in order to utilize tax losses (see 'Tax losses' above).

In addition, EU Merger Directive is implemented in Croatian CPT Law. The EU Merger Directive enables mergers and divisions covered by the provisions of the EU Merger Directive to be effected in a tax-neutral way, that is, gains realized upon mergers and divisions are not taxable and losses are not deductible, the increased value of the transferred assets cannot be depreciated for tax purposes and tax losses can be transferred and utilized. In order for the EU Merger Directive to apply, certain conditions need to be satisfied and the application of the EU Merger Directive needs to be reported to the tax authorities.

Hybrids

Hybrid instruments could be used to achieve an interest deduction for the borrower without any income tax for the lender. To date, however, there is little experience in this area in Croatia and potential benefits may be limited, especially in light of recent BEPS developments.

Discounted securities

The issue of bonds and other securities may be an effective way for a Croatian company to raise finance.

Deferred settlement

The right of the seller to receive an unknown future amount is regarded as an asset that could be taxable in the same way as unrealized gains are taxable in Croatia.

Other considerations

Concerns of the seller

The tax position of the seller can be expected to significantly influence any transaction. In certain circumstances, the seller may prefer to realize part of the value of their investment, for example, where the seller has brought forward tax losses.

Croatia does not tax gains of non-residents that are not subject to CPT in Croatia, provided the non-resident does not have a permanent establishment in Croatia. A Croatian tax resident individual may also not be subject to personal income tax.

Companies law and accounting

Croatian companies law prescribes how Croatian companies may be formed, operated, reorganized and dissolved. The accounting law prescribes that International Financial Reporting Standards (IFRS) should be followed by large entities, listed companies or companies that are in the process of being listed. Croatian Financial Reporting Standards (CFRS) should be followed by micro, small and medium-sized entities. Nevertheless, a subsidiary company that would generally be obliged to use CFRS may use IFRS instead if its parent company uses IFRS.

The companies law and accounting standards determine the accounting treatment of a business combination. In general, most combinations are accounted for as acquisitions, with merger accounting only being applied in limited circumstances. Merger accounting is not allowed under IFRS; all business combinations must be accounted for as acquisitions. The relevant Croatian accounting standards and companies law restrict merger accounting to (and make it obligatory for) a very small number of genuine mergers and group reorganizations not involving minority interests.

One of the main practical distinctions between acquisition accounting and merger accounting is that acquisition accounting may give rise to goodwill. Under IFRS, goodwill is tested annually for impairment; under CFRS, goodwill is amortized over a period of 5 years. Impairment of goodwill arising from M&As is not tax-deductible, while amortization of goodwill is tax-deductible.

Another important feature of Croatian companies law concerns the ability to pay dividends. Distributions of profit may be made only out of a company's distributable reserves. Regardless of whether acquisition or merger accounting is adopted in the group accounts, the ability to distribute the pre-acquisition profits of the acquired company may be restricted.

Group tax relief/tax consolidation

Current Croatian tax law does not provide for group tax relief/tax consolidation.

Transfer pricing

Where intercompany transactions arise post-acquisition between the buyer and the target, failure to charge an arm's

length price for services or goods provided may cause the Croatian tax authorities to challenge the transactions.

Foreign investments of a local target company

Current Croatian law does not include controlled foreign company provisions.

Comparison of asset and share purchases

Advantages of asset purchases

— Buyer can depreciate or amortize the purchase price for tax purposes.

— Buyer obtains a step-up in the cost base of assets for capital gains purposes.

— Buyer does not inherit previous liabilities of the company.

— No acquisition of tax liabilities on retained earnings.

— Possible to acquire only a part of a business.

Disadvantages of asset purchases

— Possible need to renegotiate supply, employment and technology agreements.

— A higher capital outlay is usually involved (unless debts are also assumed).

— May be unattractive to the seller, especially if a share sale would be tax exempt.

— Accounting profits may be affected by the creation of acquisition goodwill (where any impairment is tax nondeductible).

— Benefit of tax losses incurred by the target company remains with the seller.

Advantages of share purchases

— Usually a lower capital outlay (purchase of net assets only).

— Usually more attractive to the seller, both commercially and from a tax perspective (because the disposal may be tax exempt), so the price may be lower.

— Buyer may benefit from tax losses of the target company.

— Buyer may gain the benefit of existing supply or technology contracts.

— Lower transfer taxes are usually payable.

Disadvantages of share purchases

— Buyer acquires an unrealized tax liability for depreciation recovery on the difference between the accounting and tax book values of assets.

— Buyer effectively becomes liable for any claims or previous liabilities of the entity (including tax).

— No deduction is available for the purchase price.

— More difficult to finance tax-efficiently.

KPMG in Croatia

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Cyprus

Introduction

The Income Tax Law No. 118 (I) 2002 introduced major reforms of Cyprus's tax system at the time of Cyprus's accession to the European Union (EU) in 2004. The law was designed to modernize the Cypriot tax system, harmonize it with that of other European countries, ensure compliance with the European Union (EU) Merger Directive and create further opportunities for restructuring. Several other laws, such as the stamp duty and capital gains laws, were amended to allow the tax-free implementation of these provisions.

Though the tax treatment of cross-border mergers and acquisitions (M&A) has remained mainly unchanged since 2009, anti-avoidance provisions were introduced to the M&A provisions in 2015 that aim to combat abusive use of restructurings as a means to avoid the payment of tax.

Recent developments

Restructuring provisions

Under the new restructuring provisions, the tax department retains the discretion to deny tax exemptions designed to preserve the tax neutrality of reorganizations if the tax authorities take the view that the reorganization was not carried out for valid commercial reasons that reflect economic reality.

Alternatively, the tax department may set conditions for the tax neutrality of a reorganization based on, for example, the number of shares to be issued and a holding period during which the shares issued cannot be disposed (to a maximum of 3 years).

Intellectual property

In an effort to fully align the existing intellectual property (IP) regime with the Organisation for Economic Co-operation and Development's (OECD) recommendations on BEPS Action 5, amendments to the current IP regime were introduced on 14 October 2016 with effect from 1 July 2016. The amendments retain the effective tax rate of 2.5 percent of the previous regime and focus on applying the modified nexus approach and narrowing the definition of 'qualifying' IP asset.

The amendments include transitional and grandfathering provisions, allowing the previous IP regime to continue to apply until 30 June 2021. These provisions relate to the date of acquisition or development of the IP and the mode of acquisition (i.e. whether from related or independent parties).

The changes restrict qualifying IP assets to patents, computer software and IP assets that are non-obvious, useful and novel and from which the income of a taxpayer does not exceed, in a 5-year period, 7,500,000 euros (EUR) per annum (EUR50,000,000 for taxpayers forming part of a group). Further, qualifying IP assets under the modified nexus approach do not cover trademarks, including brands, image rights and other intellectual property rights used for the marketing of products or services.

The modified nexus approach requires sufficient substance and an essential nexus between the expenses, the IP assets and the related IP income in order to benefit from a patent box regime. Under the nexus approach, the application of an IP regime should depend on the level of research and development (R&D) activities carried out by the qualified taxpayer.

The following new formula determines the qualifying profits that can benefit from an IP regime:

[(Qualifying expenditure + uplift expenditure)/total expenditure] x overall IP income

'Qualifying expenditure' excludes the R&D costs of outsourcing to related parties, while the cost of outsourcing to unrelated parties is considered as part of qualifying expenditure. The amendments also provide for a maximum 30 percent uplift of qualifying expenditure, allowing qualified taxpayers to include all or part of non-qualifying R&D costs as qualifying expenditure.

Taxpayers are required to maintain books and records on income and expenditure per qualifying asset in order to track expenditure and income and ensure that the income attracting benefits in fact arose from the qualifying expenditure incurred.

Tax incentives for innovative small and medium enterprises

The Cyprus Income Tax Law was amended in 2017 to introduce detailed rules for the exemption for individuals investing in innovative small and medium enterprises (SME). To qualify, the enterprise must receive approval from a designated authority on the basis of their R&D expenses under special procedural rules. These rules explicitly refer

to accounting standards that are used to determine R&D expenses, moving away from the restrictive concept of scientific research. The tax provisions explicit define 'innovative SMEs' based on their place and duration of operations and the type of new product or geographical market concerned.

The provisions granting the incentive entered into force on 1 January 2017 for a period of 3 years unless otherwise decided by law.

The incentive is available to Cyprus tax-resident individuals who are independent private investors that invest in innovative SMEs with risk finance investments (equity and quasi-equity investments, loans including leases, guarantees or a mix thereof, to eligible undertakings for the purposes of making new investments and includes follow-on investments), either directly or through an investment fund (in the manner defined in the Cyprus Income Tax Law), or through an alternative trading platform. The investment is deducted from the individual's taxable income subject to the following limits:

— The amount deducted cannot exceed 50 percent of the individual's taxable income in the tax year in which the risk finance investment was made (before deduction of allowable insurance premiums and other contributions). The amount deducted cannot exceed EUR150,000 per year.

— Any surplus can be carried forward for 5 years, subject to the 50 percent limitation.

The rules include anti-avoidance measures that may restrict the deductibility of the expense if:

— the investor does not maintain the investment for a minimum period of 3 years, or

— the tax authorities determine that actions have taken place that aim to achieve the relevant deduction and exceed the maximum ceilings set by the rules.

Transfer Pricing

In addition to adopting the arm's length principle as a general transfer pricing measure, the Cyprus Tax Department issued a Circular on 30 June 2017 providing guidance for the tax treatment of intragroup financing arrangements, effective 1 July 2017. The circular closely follows the arm's length principle set out in the OECD transfer pricing guidelines, and it applies for all current and future intragroup financing arrangements with no possibility for grandfathering, even where a ruling was previously issued.

The circular requires a comparability analysis to be conducted to describe the intragroup financing arrangements and determine the appropriate arm's length remuneration. The comparability analysis sets requirements for both sufficient equity and adequate substance in Cyprus for the intragroup financing arrangements. Under certain conditions, taxpayers carrying out a purely intermediary intragroup financing activity may opt for a simplification measure (resulting in a minimum 2 percent after-tax return on assets).

Immovable property tax

Before 2017, the owner of immovable property situated in Cyprus was liable for an annual immovable property tax on the market value of the property as at 1 January 1980.

As of 1 January 2017, the immovable property tax is abolished and no longer applies.

Asset purchase or share purchase

An acquisition in Cyprus usually takes the form of a purchase of the shares of a company, as opposed to its business and assets. There is no capital gains tax on sales of shares or business assets except for capital gains on immovable property in Cyprus and shares in companies the assets of which, directly or indirectly, consist of immovable property in Cyprus.

Gains from sales of shares listed on a recognized stock exchange are exempt from capital gains tax. From a tax perspective, asset acquisitions are likely less attractive for the seller due to the capital gains tax on immovable property situated in Cyprus, the likely recapture of capital allowances (tax depreciation), transfer fees paid on transfer of immovable property, and possible double taxation on extracting the sale proceeds. However, the benefits of asset acquisitions for the buyer should not be ignored, particularly as purchased goodwill is tax-deductible. Some aspects of each method are discussed later in this report.

Purchase of assets

A purchase of assets (excluding real estate assets) usually results in an increase in the base cost of those assets for capital allowance purposes, although the increase is likely to be taxable to the seller. Historical tax liabilities generally remain with the company and are not transferred with the assets.

Purchase price

For tax purposes, it is necessary to apportion the total consideration among the assets acquired. It is advisable for the purchase agreement to specify the allocations, which are normally acceptable for tax purposes provided they are commercially justifiable.

Two rules affect the allocation of the purchase price:

1. The value of the trading stocks must equal the amount they would have realized on the open market.

2. For capital allowance purposes, the buyer's cost of acquisition and the seller's disposal proceeds must be, in the opinion of the Commissioner of Income Tax, what they would have cost or realized if purchased or sold on the open market.

Goodwill

Where the acquisition price includes goodwill arising from carrying on the business, such goodwill is not eligible for capital

allowances. However, if the business concern is later resold to another person and the sale price includes trade goodwill, the value of which is taxable to the seller, the goodwill's original cost to the seller is deducted from the new value of the goodwill sold and any balance is taxable to the seller.

Depreciation

Depreciation of assets charged in the accounts is ignored for tax purposes, but Cypriot tax legislation allows the cost of certain tangible assets (e.g. plant and machinery, furniture and fittings, buildings) to be written off against profits at specified rates by means of capital allowances.

As an incentive, lower rates are provided for wear and tear on certain types of plant and machinery and on industrial and hotel buildings acquired during the tax years 2012–18; after 2018, the lower rates do not apply unless otherwise provided by law.

Tax attributes

Tax loss capital allowance pools are not transferred on an asset's acquisition. They remain with the company or are extinguished.

Value added tax

Cyprus value added tax (VAT) applies at a standard rate of 19 percent on a large number of goods and services, with reduced VAT rates of 5 and 9 percent for certain supplies. Goods exported from Cyprus to non-EU destinations are subject to a zero VAT rate.

Any person established in Cyprus exercising an economic activity can be considered as a taxable person. Legal and other kinds of entities (e.g. joint ventures, partnerships and physical persons) might be considered as a single taxable person, i.e. form a VAT group, if, while legally independent, they are closely bound to one another by financial, economic and organizational links. Transactions between members of a VAT group are disregarded for VAT purposes. That is, any supplies of goods or provision of services between group members do not constitute supplies within the scope of Cyprus VAT.

Moreover, the transfer of a business as a going concern is outside the scope of VAT, provided certain conditions are met. The effect of the transfer must put the new owner in possession of a business that can be operated as such. Thus, a sale of assets is not in itself a transfer of a business as a going concern and is likely to be considered separate transactions subject to VAT as per the applicable rules. If land and buildings are being sold, it is suggested for professional advice to be sought.

Under the amended Cypriot VAT Act passed by the House of Representatives on 3 November 2017 and entering into force as of 2 January 2018, the transfer of undeveloped buildable land by persons exercising an economic activity is subject to VAT at the standard rate.

Sale of shares

The sale of shares is specifically listed as an exempt transaction in the Cyprus VAT legislation (per Part B of Schedule Seven of the Cypriot VAT Act).

Transfer taxes

No stamp duty is levied on instruments transferring ownership of shares.

Transfers of land and buildings in Cyprus are not subject to stamp duty; however, land transfer fees on the property's purchase price or market value are paid to the Land Registration Office at the following rates:

— 3 percent on the first EUR85,430 of the property's value

— 5 percent on the next EUR85,430 of value

— 8 percent thereafter.

However:

— transfer fees do not apply if the transaction is subject to VAT or the transfer is related to transactions involved in a reorganization scheme

— transfer fees are reduced by 50 percent for any immovable property that is subject to VAT.

Purchase of shares

The purchase of a target company's shares does not result in an increase in the base cost of that company's underlying assets; there is no deduction for the difference between underlying net asset values and consideration.

Tax indemnities and warranties

In a purchase of shares, the buyer takes over the target company together with all its liabilities, including contingent liabilities. Therefore, the buyer normally requires more extensive indemnities and warranties than in the case of a purchase of assets.

Tax losses

Accumulated, carried forward Cyprus tax losses generated by the target company are transferred along with the company. A company's carried forward loss cannot be set off against the profits of other companies through group relief, but it can be set off against the company's own future profits. Trading losses can be carried forward for up to 5 years from the year to which the profits relate.

Where a Cyprus target company with trading losses is acquired by a company, it may use the losses against its own future trading profits, provided there has been no major change in the nature or conduct of its trade in the period from 3 years before to 3 years after the date of acquisition. If the buyer intends to substantially change the nature of the target company's business, it may be advisable to wait until at least 3 years after the date of acquisition.

Crystallization of tax charges

While there are no specific rules under Cyprus tax law, it is advisable for the buyer to perform a due diligence to assess the tax position and related risks of the target company.

Transfer taxes

Stamp duty is payable on the consideration given for shares in a Cyprus company and is calculated on the basis of the consideration stated in the agreement.

Choice of acquisition vehicle

Several potential acquisition vehicles are available to a foreign buyer, and tax considerations often influence the choice. A capital duty applies on the introduction of new capital to a Cyprus company or branch.

Foreign parent company

The foreign buyer may choose to make the acquisition itself, perhaps to shelter its own taxable profits with the financing costs. This causes no tax problems in Cyprus, because Cyprus does not tax the gains of non-residents disposing of Cyprus shares or levy withholding tax on dividends or interest.

Local branch

As an alternative to the direct acquisition of the target's trade and assets, a foreign buyer may structure the acquisition through a Cyprus branch. Cyprus does not impose additional taxes on branch profits remitted to an overseas head office. The branch will be subject to Cyprus tax at the normal corporate rate of 12.5 percent. If the Cyprus operation is expected to make losses initially, a branch may be advantageous; subject to the tax treatment applicable in the head office's country, a timing benefit could arise due to the ability to consolidate losses with the profits of the head office.

Choice of acquisition funding

A buyer using a Cyprus acquisition vehicle to carry out an acquisition for cash needs to decide whether to fund the vehicle with debt, equity or a hybrid instrument that combines the characteristics of debt and equity.

Deductibility of interest

As a general rule, to ascertain a person's chargeable income, all outlays and expenses wholly and exclusively incurred by an individual or company in producing taxable income are deductible, including:

- interest paid on loans used to acquire business assets used in the business
- interest incurred on loans used to acquire, improve or maintain a rental asset (in which case the interest is deductible only against the rental income).

Under Cyprus tax law, interest expenses related to the acquisition of a private motor vehicle (saloon car) or a non-business asset are not tax-deductible. However, after 7 years from the date of purchase of the relevant asset, the tax authorities stop disallowing any interest as they consider the debt on the acquisition of the asset to have been paid.

Following a 2012 amendment, any interest expense related to acquisitions of shares after 1 January 2012 is tax-deductible, provided the acquired company is directly or indirectly wholly acquired (i.e. 100 percent shareholding) and holds assets used in the business. Other interest expense related to non-business assets is not deductible.

Notional interest deduction

For 2015 and later tax years, a deduction is provided on new equity (i.e. introduced into the business on or after 1 January 2015 in exchange for fully paid issued share capital) by way of a notional interest deduction (NID). The NID is calculated on the basis of a reference interest rate on new equity held by the company and used in the business. The reference interest rate is the 10-year government bond yield of the country in which the new equity is invested or of the Republic of Cyprus (as at 31 December of the previous tax year), whichever is the highest, increased by 3 percent. Its deductibility is determined under similar rules applying to the deductibility of interest.

Conditions for eligibility are as follows:

- In calculating the NID, only equity in excess of old equity is taken into account. Any equity introduced into the business on or after 1 January 2015 is not taken into account if it:
  - results directly or indirectly from reserves existing on 31 December 2014, and
  - does not relate to new assets used in the business.
- Where the new equity of a Cyprus company is derived directly or indirectly from the new equity of another Cyprus company, the NID is granted only to one of those companies to avoid duplication.
- In order to safeguard the coherence of the tax base, the NID on new equity is limited to 80 percent of the taxable profits resulting from the equity investment, prior to deducting the NID.
- No NID is allowed in the event of tax losses.
- The NID is restricted where the new equity is the result of a qualified reorganization.
- The NID may not be provided where the tax authorities consider that the company's transactions and arrangements were undertaken to benefit from the deduction without substantial economic or commercial purpose or where attempts are made to re-characterize old equity as new equity through related-party transactions and other arrangements.
- The claiming of the whole amount of NID is not compulsory; in any given tax year, taxpayers may elect to claim all or only part of the NID available.

Other considerations

Company law and accounting

The Companies Law CAP 113 (as amended; based on the United Kingdom Companies Act 1948) prescribes how Cyprus companies may be formed, operated, reorganized and dissolved. The law governing partnerships in the Partnerships and Business Names Law CAP 116 is also almost identical to that of the United Kingdom.

Cypriot case law has developed significantly since 1960. In the absence of Cypriot case law on particular legal issues, the court looks to UK case law, which is a persuasive, if not binding, authority.

Cypriot companies may be private companies limited by shares, public companies limited by shares, companies limited by guarantee, or branches of overseas companies.

There are no requirements related to the minimum authorized capital of a private limited liability company by shares. Such a company may have as few as one share as issued share capital.

The Companies Law requires companies to prepare complete financial accounts, which in their entirety should conform to International Financial Reporting Standards (IFRS).

The Companies Law allows mergers, reorganizations and cross-border mergers of Cyprus companies with companies having their registered office within EU. Cyprus has fully adopted EU Directive 2005/56 on cross-border merger of limited liability companies. Tax laws incorporate provisions for tax-free corporate reorganizations in line with the EU directive. The various forms of permissible reorganizations are described below.

Merger

— One or more companies, on being dissolved without going into liquidation, transfer all their assets and liabilities to another existing company in exchange for the issuance of shares to their shareholders representing the capital of the other company, and, if applicable, in exchange for a cash payment not exceeding 10 percent of the nominal value of the shares, or, in the absence of a nominal value, of the accounting par value of those shares.

— Two or more companies, on being dissolved without going into liquidation, transfer all their assets and liabilities to a new company that they form in exchange for the issuance of shares to their shareholders representing the capital of that new company and, if applicable, in exchange for a cash payment not exceeding 10 percent of the nominal value of the shares, or, in the absence of a nominal value, of the accounting par value of those shares.

— A company, on being dissolved without going into liquidation, transfers all its assets and liabilities to the company holding all the shares representing its capital.

Division

A 'division' is defined as an operation whereby a company, on being dissolved without going into liquidation, transfers all its assets and liabilities to two or more existing or new companies in exchange for the pro rata issuance of shares to its shareholders representing the capital of the companies receiving the assets and liabilities and, if applicable, in exchange for a cash payment not exceeding 10 percent of the nominal value of the shares, or, in the absence of a nominal value, of the accounting par value of those shares.

Partial division

A 'partial division' is defined as an operation whereby a company, without being dissolved, transfers one or more branches of activity to one or more existing or new companies, leaving at least one branch of activity in the transferring company, in exchange for the pro rata issuance of securities to its shareholders representing the capital of the companies receiving the assets and liabilities, and, if applicable, a cash payment not exceeding 10 percent of the nominal value or, in the absence of a nominal value, of the accounting par value of those securities.

Transfer of assets

A 'transfer of assets' is defined as an operation whereby a company transfers, without being dissolved, all or one or more branches of its activity to another company in exchange for the transfer of shares representing the capital of the company receiving the transfer.

Exchange of shares

An 'exchange of shares' is defined as an operation whereby a company acquires a holding in the capital of another company such that it obtains a majority of the voting rights in that company, in exchange for the issue to the shareholders of the latter company, in exchange for their shares, shares representing the capital of the former company and, if applicable, in exchange for a cash payment not exceeding 10 percent of the nominal value of the shares, or, in the absence of a nominal value, of the accounting par value of those shares.

Group relief/consolidation

Two companies are deemed to be members of a group if:

— one is a 75 percent-owned subsidiary of the other

— each is a 75 percent-owned subsidiary of a third company.

The tax legislation includes detailed rules for determining whether a company is considered a 75 percent-owned subsidiary of another company.

The set-off of losses is only allowed where the surrendering and claimant companies are members of the same group for the whole year of assessment.

For purposes of corporation tax, losses within the group companies can offset the total chargeable corporate income

in the corresponding year of assessment only. In computing the loss that may be surrendered, carried forward losses are not taken into account.

Transfer pricing

If an intercompany balance arises between the buyer and the target following an acquisition, failure to charge interest on the balance may cause transfer pricing problems in the relevant jurisdiction. For example, where the balance is owed to the target company and arm's length interest is not charged, the Cypriot tax authorities could invoke the provision of the Income Tax Law to impute interest on the balance.

As of 1 July 2017, transfer pricing guidelines for intragroup financing arrangements call for a functional analysis and a comparability study, as discussed earlier in this report.

Foreign investments of a local target company

Dividends received from abroad by a Cyprus tax-resident company are exempt from corporate income tax, provided that the dividends are not tax-deductible in the jurisdiction of the foreign paying company.

Further dividends distributed to a Cyprus tax-resident company from a company abroad are also exempt from the special defense contribution where one of two conditions are met:

— The company paying the dividend does not engage more than 50 percent directly or indirectly in activities that lead to passive income (non-trading income).

— The foreign tax burden on the income of the company paying the dividend is not substantially lower than the tax burden in Cyprus.

If the above conditions are not satisfied, then the dividends are taxed at the rate of 17 percent.

Where the dividends are subject to tax, credit is provided for the same income. Credit is not available where an arrangement was put into place for the main purpose of obtaining a tax advantage and is not genuine, having regard to all relevant facts and circumstances. An arrangement is regarded as not genuine to the extent that it is not put into place for valid commercial reasons that reflect economic reality.

Comparison of asset and share purchases

Advantages of asset purchase

— The purchase price (or a proportion not including goodwill) can be depreciated for tax purposes.

— A step-up in the cost base for capital gains tax purposes (where applicable) is obtained.

— No previous liabilities of the company are inherited.

— Possible to acquire only part of a business.

— Greater flexibility in funding options.

Disadvantages of asset purchases

— Additional legal formalities may apply, such as notification of suppliers and change of name.

— Where only assets are purchased, the initial price is higher.

— Tax losses are not acquired.

— Complications may result from rules on the allocation of the purchase price on the purchase of an enterprise.

Advantages of share purchases

— Attractive to sellers since it is exempt from corporate taxation.

— It may be possible to use tax losses, subject to conditions.

— Contracts with suppliers, employees, etc., automatically transfer.

— There is no real estate transfer tax.

Disadvantages of share purchases

— Possible restrictions on interest deductibility where the enabling conditions are not met.

— Buyer inherits all undisclosed liabilities of the target company.

— Higher tax liability will apply on the future disposal of assets due to the lower cost base.

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Czech Republic

Introduction

Czech law contains a variety of special provisions applying to mergers and acquisitions (M&A) in areas such as company law, competition, environmental protection, accounting and tax.

In general, an acquisition can be structured as a purchase of either a legal entity or assets (possibly the entire business). Depending on the requirements of the buyer, it may be appropriate to form a Czech legal entity to make the acquisition. Further reorganizations may be necessary after the acquisition to help maximize tax deductions.

The form chosen for an acquisition generally determines its tax consequences, although the tax authorities have the power to question the form where they believe the substance is different or there is an abuse of law.

Recent developments

The Czech Republic is a signatory to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting. As a member state of the European Union (EU), the country is also committed to implementing various measures contained in the EU Anti-Tax Avoidance Directives (ATAD). These developments need to be understood and taken into account when making decision about the tax and legal structuring of M&A transactions in the Czech Republic

Asset purchase or share purchase

There are two basic acquisition methods — asset deal and share deal.

Purchase of assets

The main tax effect of an asset deal is that the buyer has full tax basis in the assets acquired and the seller is subject to tax on any gain.

An asset deal may take one of two forms:

— purchase of an enterprise or part of an enterprise (an activity capable of being operated as a separate business)

— purchase of individual assets.

The main difference is that, in a purchase of an enterprise, the buyer takes over all the assets and liabilities of the seller, both disclosed and undisclosed. It is generally considered that tax liabilities do not transfer on a sale.

For the seller who realizes a gain, it is of little significance whether the sale is of assets or of an enterprise. In both cases, the gain is taxable at 19 percent and 15 percent (personal income tax). However, where the assets are sold individually, losses on the sale of some assets (e.g. receivables) are not tax-deductible.

Purchase price

The buyer and the seller can apportion the price between individual assets, and the tax authorities are unlikely to question this apportionment as long as the buyer and seller are not related.

Goodwill

In the case of a purchase of an enterprise, it is possible to carry out a valuation of the assets acquired that usually is accepted for the tax purposes of the buyer. Any part of the purchase price not attributed to the individual assets in the valuation is treated as goodwill, which can be depreciated for tax purposes over 15 years (5–10 years for accounting purposes). When no valuation is carried out, any difference between the price and the book value of the assets is classified as a valuation difference, which is depreciated for both tax and accounting purposes over 15 years.

No goodwill or valuation differences can arise on a purchase of individual assets. In this case, the whole purchase price is allocated between the individual assets.

The accounting and tax rules on goodwill also apply to negative goodwill, which arises where the price is lower than the value of the assets. Negative goodwill is treated as taxable income recognized over 15 years.

Depreciation

Generally, the buyer re-starts tax depreciation of the acquired assets (i.e. does not continue the depreciation policies of

the seller) often it acquires assets pursuant to a sale of assets or a sale of an enterprise. The buyer starts depreciating the new depreciation base, which is generally the purchase price plus related acquisition costs.

Tax attributes

Tax losses carried forward cannot be transferred in the case of an asset acquisition; they remain with the seller. Tax liabilities also remain with the seller.

Value added tax

The Czech Republic levies valued added tax (VAT) at rates of 10, 15 and 21 percent. Most goods and services are subject to the standard rate of 21 percent. A sale of assets is usually a taxable supply for VAT purposes, although some item are exempt from VAT or outside its scope (in which case a VAT clawback from input VAT previously claimed on the sold assets might arise). The sale of an enterprise is not a supply for VAT purposes; the seller remains entitled to a credit for any related input VAT.

Where a transaction involves the transfer of the whole or part of an enterprise, the buyer may have to repay input VAT claimed by the original owner on the purchase of fixed assets if the assets are used for VAT-exempt supplies in the future. The period during which such VAT may be clawed back is 10 years for real estate (including improvements) and 5 years for other assets.

The tax authorities do not recognize goodwill for VAT purposes. Where there is goodwill on a sale of assets subject to VAT (i.e. not an exempt sale of an enterprise), the goodwill element must be attributed to the other assets transferred and VAT is imposed according to the classification of the individual assets.

Transfer taxes

There are no stamp or capital duties in the Czech Republic.

The only transfer tax that may apply on an acquisition is the tax on the acquisition of immovable property (formerly real estate transfer tax), currently levied at 4 percent of the tax base.

The tax base is the higher of the agreed price and the reference value. The tax authorities calculate the reference value based on prices for similar transactions. If the tax authorities cannot determine a reference value, the tax base is the higher of the agreed price and 75 percent of the value assessed by an expert. If real estate is transferred as part of an enterprise, the tax base is based on an expert valuation.

The tax is payable by the buyer.

Purchase of shares

In a share deal, there is no step-up for the buyer or the target in relation to any premium over the accounting/tax value of the target's assets. The buyer inherits undisclosed liabilities, including the tax liabilities of the target company.

Corporations

The tax treatment of the sale depends on the status of the seller. In the case of a corporation, any gain on the sale of share investments generally is subject to corporate income tax of 19 percent as normal income unless the participation exemption applies. However, gains on the sale of shares in a Czech subsidiary (10 percent holding for at least 12 months) are tax-exempt for corporate sellers resident in the Czech Republic, the EU, Iceland, Norway and, as of 2016, Liechtenstein.

The exemption cannot be applied if the parent company or the subsidiary:

— is exempt from corporate income (or similar) tax

— may claim a corporate income tax exemption or corporate income tax relief, or

— is subject to corporate income tax at a rate of 0 percent.

The exemption also applies to sales of some non-Czech subsidiaries. For the exemption to apply, a minimum of 10 percent of the share capital of the company whose shares are sold should be held for at least 12 months, and this company must be tax-resident in either the EU or a country with which the Czech Republic has concluded a tax treaty and that has a corporate tax rate of at least 12 percent. Losses on disposal are not deductible, except in the case of shares in a joint stock company (a.s.) or European company (SE) held for trading purposes.

Individuals

In the case of an individual who has not treated the shares as a business asset, a gain on the sale of shares in a joint stock company or SE acquired before 31 December 2013 is tax-exempt where the securities have been held for more than 6 months and do not represent more than 5 percent of registered capital and voting rights for 24 months preceding the sale. Gains on the sale of securities acquired before 31 December 2013 representing more than 5 percent of registered capital and voting rights and any securities acquired from 1 January 2014 are exempt if held for 3 years. If the required holding period is not fulfilled, the gain is taxable at a rate of 15 percent.

No tax is payable where the taxable sales of securities do not exceed 100,000 Czech crowns (CZK) in a tax year.

A gain on the sale of an interest in a limited liability company (s.r.o.) is exempt from tax if it has been held for more than 5 years.

Where the buyer is a Czech tax-resident and the seller is not based in the EU or European Economic Area (EEA), the buyer is required to withhold a so-called 'security tax' as an advance against tax payable unless treaty protection is available. The rates are 1 percent for income from the sale of 'investment instruments' as defined by the Czech law and 10 percent for income from the sale of an interest in an s.r.o. The sale of shares in an a.s. and s.r.o. is exempt from VAT with no right to deduct input VAT.

Tax indemnities and warranties

In a share acquisition, the buyer takes over the target company and, indirectly, all of its related liabilities, including tax liabilities. Therefore, the buyer normally needs more extensive indemnities and warranties than in the case of an asset acquisition, where tax liabilities do not transfer.

Tax losses

Tax losses may be carried forward for 5 years. The tax law prevents the use of tax losses where there is a substantial change in the persons directly participating in the company's equity or management and less than 80 percent of the company's income in the year in which the loss is to be used is derived from the same activities as in the year when the loss arose. A change in the ownership of more than 25 percent of the registered capital or voting rights is always a substantial change. A taxpayer can apply to the authorities to confirm the availability of the carried forward losses after the end of the taxable period in which the losses are to be used.

Crystallization of tax charges

There are usually no exit charges on leaving the group. The main exceptions are:

— withholding tax (WHT) on dividends where the 12-month minimum holding period has not been met

— WHT on interest and royalties where the 24-month minimum holding period has not been met

— tax on the acquisition of immovable property where a sale of shares acquired in exchange for a contribution of real estate is made before 2014 within 5 years.

Pre-sale dividend

Pre-sale dividends are rare in practice. If there is a qualifying corporate shareholding, both dividends and capital gains are exempt (i.e. the tax treatment does not differ). If the dividends are paid to an individual, there is no exemption from taxation; the dividends are always taxable while the gain can be exempt. Therefore, dividends are not usually tax-efficient.

Transfer taxes

There are no stamp or capital duties in the Czech Republic. Administration fees are payable on certain services rendered by various government bodies.

Tax clearances

Most transactions and reliefs are not subject to tax clearances. Some formalities need to be fulfilled for corporate reorganizations.

In a share deal, the seller is usually required to provide confirmation from the tax authorities that there are no tax arrears, although this does not preclude additional tax being assessed in the future.

A taxpayer can ask the tax authorities for a tax ruling relating to certain issues in advance (e.g. use of tax losses, transfer pricing). There is no general ruling system.

Choice of acquisition vehicle

Several potential acquisition vehicles are available to a foreign buyer, and tax factors often influence the choice. There is no capital duty on the introduction of new capital to a Czech company, including a Czech-registered SE or branch.

Local holding company

A Czech holding company is usually used as an acquisition vehicle where the buyer wishes to ensure that the taxable profits of the Czech target company can be offset against tax-deductible interest expenses from an acquisition loan. Under a typical structure, the company that makes the acquisition subsequently merges with the target so that the taxable income of the target and the expenses related to the acquisition are within one entity. Interest on acquisition loans is generally non-deductible. However, where the target company merges with the buyer within 1 year, there may be a case to treat the interest expenses as tax-deductible. Care must be taken in implementing such structures, since they recently have attracted attention of the tax authorities. In certain circumstances, courts have rejected tax deductions for acquisition-related borrowings.

The legal forms most commonly used are limited liability companies and joint stock companies because only these two legal forms allow the exemption from taxation of profit distributions under the EU Parent-Subsidiary Directive. They also give limited liability to the shareholders. An SE could also function as an acquisition vehicle but is more administratively burdensome.

Foreign parent company

The foreign buyer might choose to acquire the Czech target company itself because it wishes to offset the interest on an acquisition loan against its own profits, which is possible in certain tax jurisdictions. As noted earlier, cross-border mergers of Czech companies are allowed but are more administratively demanding than mergers of two Czech companies.

Non-resident intermediate holding company

Non-resident intermediate holding companies have historically been used as a tax-efficient means of making inward investment where a relevant tax treaty provided more favorable tax treatment for capital gains or dividends. International developments, such as the Organisation for Economic Co-operation and Development's (OECD) base erosion and profit shifting (BEPS) project, mean that closer attention will be paid to the substance of such holding company structures.

Local branch

Under some circumstances, a foreign parent company may structure its investments through a Czech branch. Czech commercial law requires a branch to be registered where the foreign parent company systematically carries on business in the Czech Republic and has no local subsidiary.

Generally, the tax status of a Czech branch does not differ from the tax status of a local company (i.e. same rules for the tax base calculation, same tax rate). However, there are some differences. For example, the distribution of profit by a Czech branch is not regarded as a dividend. There is no branch profits tax.

Joint venture

A joint venture can be either corporate (with the joint venture partners holding shares in a Czech company) or unincorporated (usually a partnership), which is (at least partially) tax-transparent.

Choice of acquisition funding

A buyer using a Czech entity to carry out an acquisition can finance the acquisition vehicle with debt, equity or a combination of both.

Debt

The principal advantage of financing an acquisition with debt is the potential interest deductibility, as opposed to the payment of dividends that are not tax-deductible. Any related expenses (e.g. loan arrangement fees) are usually deductible. Moreover, debt financing has the advantage of avoiding a dilution of equity. Therefore, the costs of debt financing are lower than the costs of equity. It is important to choose an acquisition vehicle that allows the offsetting of interest expenses against taxable income.

According to the Czech tax law, interest on loans taken out less than 6 months before the acquisition of a subsidiary is generally non-deductible (see later in the report). The tax-deductibility of interest on loans provided by a related party can also be limited by the Czech thin capitalization and transfer pricing rules.

Deductibility of interest

Expenses paid or payable for the purpose of earning taxable income are generally tax-deductible. Therefore, interest on acquisition financing should be deductible subject to transfer pricing and thin capitalization considerations.

This general rule is subject to some exceptions:

— Interest paid by a Czech company is generally deductible on an accrual basis. However, where it is payable to an individual who does not keep double-entry books, it can only be deducted when paid.

— When the interest or other revenue is derived from the borrower's profit, the financial expenses on the loans or credits are not tax-deductible.

— Interest should be incurred to earn taxable income. Dividends and other income subject to WHT as a final tax are not taxable income for this purpose.

— Expenses paid in connection with a holding in a subsidiary company are generally non-deductible. The law includes a rebuttable presumption that interest on loans taken out less than 6 months before the acquisition is paid in connection with the holding in the subsidiary. There is also a rebuttable presumption that 5 percent of distributions received from a subsidiary is a disallowable indirect cost of holding the investment. Such costs can be added to the base cost of the shares when calculating gains on future disposals. The definition of 'subsidiary' for this purpose is drawn from the legislation enacting the EU Parent-Subsidiary Directive, which includes a requirement for the parent to hold 10 percent of the shares for at least 12 months.

A merger of the target with the holding company can mitigate the last two of these concerns. Alternatively, it is possible to convert the target into a tax-transparent entity, so that the buyer's interest expense becomes deductible against its share of the profits of the target's business. Care must be taken in implementing such structures, since the tax-deductibility of acquisition loan interest may be vulnerable to challenge in some circumstances.

The Czech thin capitalization provisions restrict the deductibility of interest where the borrower has insufficient equity. Financial expenses arising from loans and credits received from related parties in excess of four times (six times for banks and insurance companies) the borrower's equity are not tax-deductible. Interest on loans and credits received from unrelated parties, or those secured by a related party, is fully deductible on general principles, except for interest on back-to-back loans (i.e. where a related party provides a loan, credit or a deposit to an unrelated party, which then provides the funds to the borrower), which is treated as interest on related-party debt.

Notwithstanding these provisions, financial expenses that directly relate to taxable income (e.g. interest income) can be deducted up to the amount of that income.

In addition, the forthcoming change in the taxation of interest expense caused by the application of ATAD should be noted.

The directive provides, among others, for limitation of deductibility of borrowing costs (which includes interest, finance lease payments, capitalized interest or its amortization, hedging arrangements relating to borrowings, and certain foreign exchange losses). The limitation applies for both internal and external borrowing costs.

Based on the ATAD, the deduction of borrowing costs (less borrowing income) is generally limited to 30 percent of earnings before interest, taxes, depreciation and amortization or EUR 3 million. The rules allow flexibility and exemptions on transposition, and they include de minimis thresholds, escape clauses and a grandfathering provision. EU member states must implement the main provisions of the directive in their national legislation (by 31 December 2018), with effect as of 1 January 2019. It is not yet clear how the Czech Republic will implement the rules.

Withholding tax on debt and methods to reduce or eliminate this tax

The Czech Republic levies WHT of 15 or 35 percent on interest payable to non-resident lenders, which is often reduced by a tax treaty to zero. Interest paid to certain associated EU resident companies is free of WHT under the EU Interest and Royalties Directive, provided the recipient is the beneficial owner of the interest and the tax authorities confirm the entitlement to the exemption.

The 35 percent rate applies where the interest is paid to residents of countries that have no tax treaty with the Czech Republic or arrangement with the country for the exchange of information on tax matters.

The Czech tax law allows interest to be re-classified as a dividend where it is non-deductible due to a breach of the transfer pricing or thin capitalization rules. This can have adverse WHT consequences. This reclassification does not apply to EU or EEA lenders.

Interest paid by a Czech-resident company to a Czech-resident lender is not subject to WHT.

Checklist for debt funding

The following factors should be taken into account when debt funding is being considered:

— deductibility of interest connected with an acquisition of a company

— thin capitalization rules, where a loan is granted by a related party

— transfer pricing rules, which require interest on a related-party loan to be set at arm's length

— effective tax rate of the lender

— new debt funding rules under the ATAD transposed in Czech domestic law

— reduction of or exemption from WHT.

Equity

A buyer can use equity to fund the acquisition rather than debt. The main way to increase equity is by issuing new shares.

The main disadvantage of equity financing is dilution of the shareholders' ownership (in the case of an increase of equity made disproportionately to the voting rights of each shareholder) and the non-tax-deductibility of dividends. Equity financing generally is considered less preferable than debt financing.

However, in certain situations, equity financing might be preferable, such as where:

— the target company is a loss-making company

— the debt-to-equity ratio is too high and exceeds the thin capitalization limits

— a higher effective tax rate applies in the home country of the lender

— non-tax-related business reasons exist, such as credibility of a company or regulatory restrictions.

Tax-free corporate reorganizations

There are no comprehensive tax rules on corporate reorganizations. The rules enacted under the EU Merger Directive and Directive on Cross-border Mergers is intended to allow reorganizations to take place on a tax-neutral basis. The tax authorities have the power to challenge the intended tax effects of a transaction on the basis that the substance of the transaction is other than the form but this is rare in practice. Typical transactions are described below.

Contribution in kind

The Income Tax Act (ITA), section 30(10) requires the recipient of a contribution in kind to the capital of a company to continue the tax depreciation policies of the person making the contribution. On a cross-border contribution to a Czech company, the recipient must continue the tax depreciation of the contributed assets based on the original purchase price of the contributed asset calculated in CZK on the date of contribution and using the Czech tax rules. Tax depreciation on the contributed assets can only be claimed up to the difference between the original purchase price and the tax depreciation already claimed by the contributor. Except where the EU Merger Directive applies (Section 23a, ITA), the tax law is silent on the treatment of the person making the contribution; however, according to the accounting rules, the contributor does not realize a gain in such a case but records the shares received at the net book value of the asset contributed.

Section 23a of the ITA does not refer to contributions of assets. The section refers only to a contribution of an enterprise or part of an enterprise as defined for the purposes of the Civil Code (i.e. an activity that can be operated as a separate business, as required by the Merger Directive, and including all liabilities, both disclosed and undisclosed) involving Czech and/or EU-resident companies (but excluding both types of Czech partnership).

The law states explicitly that the person making the contribution does not realize a taxable gain and permits the transfer of reserves and tax losses. Further, the law provides that the person receiving shares in exchange for a qualifying contribution should record these shares at market value for tax purposes. This does not apply where the contributor transfers the shares within 1 year. Moreover, tax attributes cannot be transferred where the main or one of the reasons for the contribution is to reduce or avoid the tax liability.

A contribution of assets that does not qualify as an enterprise is regarded as taxable supply for VAT purposes where the contributor claimed an input VAT deduction when the assets were purchased. The contributor and buyer are jointly liable for

the VAT. The contribution of some asset classes can be exempt from VAT (e.g. real estate) where certain conditions are met.

A contribution of an enterprise or part of an enterprise is not a taxable supply for VAT purposes. Nevertheless, a company that receives an enterprise or part of an enterprise may be obliged to repay input VAT claimed originally by the contributor, where the fixed assets are later used for VAT-exempt supplies. The general clawback period is 5 years, extended to 10 years for buildings.

Until 31 December 2013, contributions of real estate to the registered capital of a company were exempt from real estate transfer tax where the contributor retained an interest in the recipient for 5 years. The exemption was cancelled for contributions from 1 January 2014.

There are no stamp or capital duties.

Merger

In a merger, the predecessor company ceases to exist without going into liquidation and all its assets and liabilities pass to the successor. There are no detailed tax rules on mergers except for cases dealt with by Section 23c of the ITA (which implements the EU Merger Directive). In general, a merger is tax-neutral. The transfer of fixed assets is at the tax residual value, and any goodwill arising cannot be depreciated for tax purposes.

For qualifying mergers:

— no gain or loss is realized by the shareholders of the dissolving company on their disposal of its shares, except to the extent that they receive cash

— the value of the shares received is equal to the value of the shares in the company that ceases to exist (i.e. no step-up in the value of the shares)

— tax depreciation policies of the company that ceases to exist are continued by the successor(s)

— tax losses arising after EU accession are transferred, provided that tax avoidance is not a main purpose of the transaction

— reserves and provisions are automatically transferred, subject to the same tax avoidance restriction that applies on the transfer of losses.

The companies concerned have to be resident in the Czech Republic or another EU Member State. Based on the EU Directive on Cross-Border Mergers, it is possible to merge a Czech company with any company registered in an EU member state.

For accounting and income tax purposes (but not legally or for VAT purposes), it is possible for the effective date of a merger to be up to 12 months earlier than the date on which the application for registration of the merger is filed with the commercial court.

There is no real estate transfer tax, VAT or stamp/capital duty on a merger. Nevertheless, the successor may be obliged to repay input VAT claimed originally by the predecessor, where the fixed assets acquired are later used for VAT-exempt supplies. The general clawback period is 5 years, extended to 10 years for buildings.

Demerger

In a demerger, the predecessor company ceases to exist and its assets are transferred to two or more newly incorporated successor companies, which issue shares to the shareholders of the predecessor. Again, the ITA is generally silent on the effects except for the provisions implementing the EU Merger Directive legislation (Section 23c ITA). The same rules apply as in the case of a merger (with the necessary changes), namely, tax-neutrality with regard to transfers of assets, no tax deduction for the depreciation of goodwill, transfer of tax losses and possible transfer of reserves and provisions by agreement.

Where the fixed assets are later used for VAT-exempt supplies, the successors may be obliged to repay input VAT originally claimed by the predecessor. The general clawback period is 5 years, extended to 10 years for buildings.

Spin-off

A spin-off is an alternative to a demerger. The demerged company does not cease to exist, but the spin-off part is transferred to an existing or newly incorporated company. The spin-off is tax-neutral. The transfer of tax provisions, tax reserves and tax losses to the successor is possible to the extent that the transaction can be commercially justified.

There is no real estate transfer tax, VAT or stamp/capital duty. Again, the successor may be obliged to repay input VAT claimed originally by the demerged company, where the fixed assets are later used for VAT-exempt supplies.

Tax losses and reorganizations

When losses are transferred on a merger, demerger or spin-off, they can only be used against the profits derived from the activity that generated them. Similarly, any losses of the surviving company can be used only against the profits generated by the same activity. Where an activity is transferred through a contribution of an enterprise, the losses transferred can only be used against the profits of the activity transferred. There is no restriction on the use of the losses by the transferee.

Hybrids

A buyer can combine both debt and equity to achieve the desired debt-to-equity ratio.

Generally, the Czech law does not deal with hybrid instruments, and the tax treatment tends to follow the legal form (subject to the substance-over-form rule). Anti-hybrid rules must be introduced into the Czech tax law as of 1 January 2020 to

implement the ATAD. How the rules will be implemented in the Czech Republic is not yet clear.

Discounted securities

The tax treatment of securities issued at a discount to third parties generally follows the accounting treatment. The discounted amount should be written-off over the period until maturity. Under domestic legislation, interest paid to non-residents and the accrued discount are each subject to 15 percent WHT, subject to reductions under a tax treaty or the EU Interest and Royalties Directive.

Deferred settlement

An acquisition often involves an element of deferred consideration, the amount of which can only be determined at a later date on the basis of the post-acquisition performance of the business. The right to receive an unknown/conditional future amount should not be recognized for either tax or accounting purposes, applying the prudence principle. Where receipt of an agreed amount is simply deferred without conditions, it is recognized as taxable income at the time of the sale.

Other considerations

Both the substance-over-form rule and the abuse of law concept need to be taken into account when structuring transactions. The tax authorities have the power to ignore the strict legal form and adjust the tax effects of any transaction based on these concepts. The abuse of law doctrine applies where a person exercises their rights to the detriment of others or society in general. The Czech courts cannot be expected to provide legal protection to such an exercise of rights that is, at the same time, an abuse of those concepts.

Concerns of the seller

As the Czech tax law provides for an exemption from the taxation of capital gains for many sellers, this is usually the main area of concern.

Company law and accounting

The Czech company law provides for the following legal entities:

— general partnership (v.o.s.)

— limited partnership (k.s.)

— European company (SE)

— limited liability company (s.r.o.)

— joint stock company (a.s.).

The shareholders of an s.r.o. are liable for the unpaid liabilities of the company, up to the total amount of unpaid contributions to the registered capital. The shareholders of an a.s. or an SE (governed by Czech law) are not liable for the unpaid obligations of the company. The SE is administratively demanding to establish, so it is not often used.

A general partnership is a tax-transparent entity. A limited partnership is partly tax-transparent (for the income apportioned to the general partner). The main disadvantage of these two legal forms is the unlimited liability of the general partners. The partners in a v.o.s. are liable for all unpaid liabilities of the partnership. In the case of a k.s., a general partner is fully liable for unpaid liabilities, while a limited partner is only liable up to the amount of unpaid contributions to capital.

Generally, the Czech accounting rules are governed by the Act on Accounting. Further detailed guidance is provided in the Decrees on Double-Entry Accounting and Czech National Accounting Standards. All businesses registered in the Czech Commercial Register are obliged to use double-entry bookkeeping.

The accounting period generally is defined as a period of 12 consecutive months. The accounting unit can either use a calendar year or specify a business year-end other than 31 December. Statutory financial statements consist of a balance sheet, a profit and loss account and notes. Cash flow statements and statements of equity changes must also be prepared in certain cases (depending on the entity's turnover, value of fixed assets and number of employees). The Act on Accounting states that certain business units are subject to mandatory statutory audits and must prepare separate annual reports. Additional filings may need to be made in the event of a reorganization.

Group relief/consolidation

There is no tax consolidation for Czech corporate tax purposes. Thus, the use of a highly leveraged Czech holding company to acquire a target is ineffective for tax purposes unless followed by a merger or a transformation of the target to a partnership.

Transfer pricing

Generally, prices between related parties should be set at arm's length. The Czech ITA has a broad definition of 'related parties'. While it does not provide for mandatory transfer pricing documentation, guidelines have been issued that describe standards that the tax authorities expect to be followed. A taxpayer can ask the tax authorities for an advance tax ruling relating to the arm's length price.

Taxpayers who fulfill specific conditions are required to make special disclosure of transactions with related parties, via an appendix to the annual corporate tax return. Separate disclosure of transactions by each separate related party is required. The tax authority is expected to use the information to determine the primary areas of focus for transfer pricing investigations.

The Czech Republic signed the Multilateral Agreement on Country-by-Country Reporting, which was initiated via the OECD BEPS project. The implementing legislation entered into force in 2017, and the country-by-country reporting obligation took effect in September 2017.

Dual residency

The Czech ITA defines a 'resident company' as one that has its seat in the Czech Republic or whose place of effective management is in the Czech Republic. The seat or effective management of a Czech company can be transferred outside the Czech Republic, which can result in a change of tax residency, depending on the relevant tax treaties. The tax implications of any such change of tax residency would need to be examined case-by-case.

Foreign investments of a local target company

There is no controlled foreign company (CFC) legislation in the Czech Republic. As noted earlier, Czech tax law contains a substance-over-form rule and an abuse of law concept that may need to be considered when implementing international financial structures.

CFC rules should be introduced into the Czech tax law with effect as of 1 January 2019 as a result of the implementation of ATAD. How the rules will be implemented in the Czech Republic is not yet clear.

Comparison of asset and share purchases

Advantages of asset purchases

— An asset deal can be structured as an acquisition of individual assets or an enterprise as a going concern.

— It is possible to acquire only part of a business.

— The purchase price, including goodwill, can be depreciated for tax purposes.

— Interest payable on borrowings is generally deductible.

— Except where an enterprise is purchased, liabilities are not inherited (even then, tax liabilities should be excluded), but in some cases, the buyer may be jointly liable for related debts where they knew or should have known about them.

Disadvantages of asset purchases

— Additional legal formalities apply in the areas of notification of suppliers, change of name and employment law (although on a purchase of an enterprise, employment contracts transfer automatically).

— Where only assets are purchased, the initial price is usually higher.

— Where the sellers are individuals, the existence of exemptions from tax for sales of companies makes this structure much less attractive.

— Tax losses are not acquired.

— Complications may result from rules on the allocation of the purchase price on the purchase of an enterprise.

— The tax on acquisition of immovable property (real estate transfer tax) may affect the price.

— Possible VAT clawbacks, if the transaction is VAT-exempt or if the business makes VAT-exempt supplies in the future.

Advantages of share purchases

— Attractive to sellers, especially if they are individuals or exempt from corporate tax on any gains.

— Possible to use historical tax losses, subject to restrictions.

— Contracts with suppliers, employees and others automatically transfer.

— No real estate transfer tax or capital taxes.

Disadvantages of share purchases

— No tax deduction for the purchase price until shares are sold (if the sale is not exempt).

— Interest deductibility may be restricted unless a merger follows the acquisition.

— Buyer inherits all undisclosed liabilities of the target company, including tax liabilities.

— No step-up in the cost base of assets is possible.

KPMG in Czech Republic

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Denmark

Introduction

Danish tax rules and practice have changed fundamentally in recent years. A number of rules have been introduced to prevent erosion of the Danish tax base, and the Danish tax authorities have adopted a restrictive attitude toward structures aimed at reducing the Danish tax base. However, the Danish parliament has also introduced a number of specific tax initiatives that make it more attractive to invest in Danish companies and jobs. This report starts with a brief description of the most important recent developments.

This report also addresses three fundamental questions facing a prospective buyer:

— Should the target's shares or assets be acquired?

— What will the acquisition vehicle be?

— How will the acquisition vehicle be financed?

At the end of the report, we briefly describe some accounting, company law and tax issues that may be relevant for a potential buyer.

Generally, the discussion in this report is restricted to Danish incorporated companies, namely, public limited companies (A/S) and private limited companies (ApS). The information is based on Danish legislation as of 1 January 2018.

Recent developments

Danish tax law and practice is constantly changing, and amendments are usually comprehensive, complex and detailed. Generally, structures that were tax-efficient 5 years ago may now be either inefficient or exposed to tax audits and contingent tax liabilities.

Developments in the mergers and acquisitions (M&A) tax area over the past 5 years amount to a tightening of anti-avoidance rules and a more aggressive approach by the tax authorities to arrangements that erode the Danish tax base. These developments make it difficult for investors to establish robust, tax-efficient structures, so it is important to consider all aspects of a transaction or acquisition structure to avoid adverse and unintended tax consequences. A number of structures still function, but local advice should be sought when planning a structure involving Danish companies and foreign holding companies, particularly when debt is incurred or increased in the Danish companies.

Aggressive approach to preventing tax erosion

The tax authorities are challenging dividend and interest payments routed through intermediate holding companies resident in countries with a tax treaty with Denmark (e.g. Luxembourg) that is more favorable than the country of residence of the investors/lenders (e.g. Jersey or another tax haven). The tax authorities claim that the intermediate holding companies are conduit companies (not the beneficial owners) and therefore should be disregarded for Danish tax purposes. In several cases, intermediate holding companies have been denied European Union (EU) directive or treaty protection, and dividend and interest payments have been subject to Danish withholding taxes even though the de facto beneficial owner is resident in a tax treaty country.

Although a few rulings from the Danish High Court have provided some clarification, a significant amount of cases are still pending in the Danish court system and more cases are expected. As the legal position is still unclear and legal practice in this area seems to be fast-moving, KPMG in Denmark recommends considering holding structures carefully before buying a Danish company in order to avoid or reduce exposure to withholding tax (WHT).

In 2012, the Danish Parliament passed a bill in an attempt to prevent the use of Danish companies as conduit companies. As a result of this bill, dividend payments from a Danish company to a foreign parent company are subject to 27 percent WHT (which is expected to be reduced to 22 percent) where dividend payments are a redistribution of dividend payments received from a subsidiary outside Denmark and the Danish company is regarded as a conduit company and therefore not the beneficial owner of the dividends received. However, this anti-abuse rule does not apply if the distribution from the Danish company is tax-exempt under the EU Parent-Subsidiary Directive (90/435).

Thus, the Danish WHT on dividend payments from Danish conduit companies is only levied on payments to parent companies in tax treaty countries outside the EU.

Finally, the Danish WHT is reduced in accordance with a relevant tax treaty, provided this company is for Danish tax purposes regarded as beneficial owner of the dividend payment.

As of 1 May 2015, Denmark adopted two general anti-avoidance rules (GAAR) with the aim of preventing abuse of tax treaties and EU direct tax directives.

As background, on 27 January 2015, the EU Council amended the EU Parent-Subsidiary Directive by adopting a GAAR that must be implemented in national law by 31 December 2015. Further, the Organisation for Economic Co-operation and Development (OECD) has proposed a general anti-avoidance rule in the context of the Base Erosion and Profit Shifting (BEPS) Action 6.

The bill introduces a directive GAAR and a tax treaty GAAR in sections 3(1) and (3), respectively, of the Danish Tax Assessment Act. The scope of the directive GAAR encompasses the EU's Parent-Subsidiary Directive (2011/96/EU), Interest-Royalty (2003/49/EC) and Merger Directive (2003/133/EF), whereas the tax treaty GAAR is applicable to income tax treaties entered with Denmark. Under both rules, a taxpayer cannot obtain the tax benefits of a directive or tax treaty if obtaining such benefit was one of the main purposes of any arrangement or transaction resulting in that benefit.

During 2016 and 2017, the Danish tax authorities issued a number of binding rulings, on the application and interpretation of the domestic GAAR. However, the legal position still seems to be unclear, and more cases and binding rulings are expected, so KPMG in Denmark recommends a close review to determine whether a structure may be subject to the GAAR.

Both GAARs apply as of 1 May 2015 to existing and new arrangements and transactions (i.e. no grandfathering).

Current focus on incentives for growth

The aim of some of the most recent developments in Danish tax law is to create incentives for growth. As a result of this focus, the corporate tax rate was reduced from 25 percent in 2013 in stages as follows:

— 2014: 24.5 percent

— 2015: 23.5 percent

— 2016: 22 percent.

The tax rate has not changed since 2016, and remains at 22 percent for 2018.

Since 1 January 2013, capital gains on unquoted portfolio shares (i.e. shareholdings below 10 percent) are tax-exempt.

Finally, businesses that have had research and development (R&D) expenses resulting in tax losses are currently entitled to a cash reimbursement of 22 percent of the losses. As of income year 2015, the upper ceiling of the reimbursement is the tax value of 25 million Danish kroner (DKK), i.e. DKK5.5 million.

Asset purchase or share purchase

A buyer may acquire a Danish company (the target company) by purchasing either the assets or the shares in the company. Most transactions involving Danish target companies are share transactions because the capital gain realized by the seller on the sale of shares is often tax-exempt. By contrast, the Danish target company is liable to tax on gains realized on the sale of the assets. However, a purchase of assets may still be attractive in a number of situations, such as where the target company has tax losses carried forward in the tax group that can offset the capital gains tax, or where the buyer wishes to acquire a part of the target company's business.

Purchase of assets

Even though the historical tax liabilities remain with the seller, a buyer may still wish to carry out some due diligence before purchasing the assets. This could be done to reveal any non-compliance practice or procedures in relation to the assets or the nature and tax depreciation profile of the assets for valuation purposes, etc.

A foreign company that acquires the assets of a Danish company and continues the business activity in Denmark is normally regarded as having a permanent establishment (PE) in Denmark after closing. The income derived by the PE is taxable in Denmark in accordance with Danish tax legislation as well as any tax treaty with the country in which the foreign company is resident.

Purchase price

When selling depreciable assets, the buyer and seller must allocate the total cash value of the transfer to each category of depreciable assets included in the sale. The agreed allocation serves as the basis for capital gains taxation of the seller and as the depreciation basis/acquisition price for the buyer.

The Danish tax authorities may challenge either the total cash value or the allocation between depreciable assets. Where no allocation is made, the tax authorities may assess an appropriate allocation and both the seller and buyer are obliged to apply the assessed values.

The transfer agreement should carefully consider the purchase price allocation between the categories of assets because the depreciation profile for the various categories varies, as explained later in this report.

Goodwill

Goodwill acquired by a Danish company may be amortized by up to one-seventh annually.

Depreciation

The various categories of assets have different depreciation profiles, as described earlier. Consequently, the purchase

price allocation in an asset deal is of major importance for the estimate of future free cash flow.

Most operating assets, such as plant, machinery, equipment and motor vehicles, may be depreciated by up to 25 percent per year in accordance with the declining-balance method. The depreciation rate can vary from year to year at the taxpayer's discretion. The price of minor assets, software and certain equipment for R&D may be written off in the year of acquisition, whereas certain heavy fixed assets and infrastructural facilities are subject to a reduced depreciation rate.

Buildings, other than, for example, office buildings, are depreciated individually using the straight-line method by up to 4 percent a year. Office buildings are generally not depreciable unless integrated with or closely related to a manufacturing or depreciable building.

Intangibles acquired by a Danish company may be depreciated by up to one-seventh annually. Knowhow and patents are subject to favorable rules that allow immediate write-off of the purchase price in the acquisition year.

Generally, the annual depreciation charge for tangible and intangible assets is computed on the basis of the cash equivalent of the cost price. The cash equivalent price is the actual cost price less the excess of the nominal value of loans (taken over from the seller) over market value.

Tax attributes

Tax losses and the tax balances of the target are not transferred to the buyer in an asset acquisition. They remain with the company or are normally used at the time of the transaction.

Value added tax

The Danish value added tax (VAT) rate is currently 25 percent and applies to most supplies of goods and services by VAT taxable entities.

The transfer of a business (or part of a business) as a going concern is outside the scope of VAT provided that the following conditions are met:

— The buyer continues the transferred business.

— The seller no longer continues the transferred business.

— Both seller and buyer are registered for VAT purposes in Denmark.

A transfer of a going concern must be notified to the Danish tax authorities by the seller within 8 days of the transfer.

A transfer of a going concern may also lead to a transfer of the VAT adjustment liability under the capital goods scheme when certain investment goods are included in the transfer. Alternatively, the VAT adjustment liability must be calculated and settled with the Danish tax authorities.

Where receivables from VAT-taxable supplies are transferred as part of the business transfer, there is a risk that the buyer would not be entitled to adjust the output VAT if the receivables become irrecoverable debt. Local advice should be sought to ensure that the output VAT can be adjusted for such irrecoverable debt by the buyer.

As a main rule, where the transfer does not qualify as a transfer of a going concern for VAT purposes, then the transfer generally is treated as a sale of assets subject to Danish VAT.

When the transfer of a business consists of a sale of shares, the transaction is VAT-exempt.

Transfer taxes

No stamp duty is payable on a transfer of assets or shares.

Registration of a change of ownership of land and buildings is subject to a duty of DKK1,660 plus 0.6 percent (as of 2018) of the fair market value.

Mortgage instruments are subject to a duty of DKK1,660 plus 1.5 percent (as of 2018) when the loan is raised or re-financed.

Purchase of shares

There are no immediate Danish tax consequences for a foreign company that acquires the shares of a Danish company.

Apart from the carry forward of losses described later in this report, the tax position of the acquired Danish company remains unchanged. Consequently, there is no possibility for a tax-free step-up in the tax basis of the assets of the acquired company.

It is not possible to obtain assurance from the tax authorities that a potential target company has no tax liabilities or whether a potential target post-closing may become involved in any tax disputes.

Tax indemnities and warranties

As the buyer takes over the target company together with all related liabilities, including contingent liabilities, the buyer normally requires more extensive indemnities and/ or warranties about any undisclosed tax liabilities of the target company. The extent of the indemnities or warranties is a matter for negotiation.

The buyer usually initiates a due diligence review where significant sums or complex tax affairs are involved. A normal part of the due diligence process involves an in-depth review of the historical tax affairs of the target company by the buyer's advisors.

Tax losses

Generally, carried forward tax losses may be carried forward indefinitely subject to certain limitations.

Thus, tax losses carried forward can fully offset taxable income up to DKK8,205,000 (as of 2018), but they may only

reduce taxable income over the threshold by up to 60 percent. Losses generated during the income year may be offset in full.

On a change of ownership, a tax loss carried forward may become restricted and consequently cannot be used to reduce the taxable income to less than the net financial income (interest and similar income and expenses), including lease income from operating assets and ships that are subject to tax depreciation. As such, the tax losses carried forward can still offset operating profits.

A change of ownership takes place where more than 50 percent of a Danish company's share capital or voting power at the end of any income year is held by shareholders other than those who owned it at the beginning of the year in which the loss arose. In certain circumstances, the assessment of the change in ownership is made at the ultimate parent level, which means indirect change of ownership may trigger the restriction. Where the company is inactive at the time of the change of ownership, the loss carry forward may be forfeited.

Tax losses carried forward by the target company at closing generally are not available for companies participating in the buyer's tax group.

Tax clearances

Taxpayers generally may apply to the tax authorities for a binding ruling regarding the tax consequences of a specific transaction. A ruling is generally binding for 5 years.

Choice of acquisition vehicle

A wide range of acquisition vehicles is available to a foreign buyer who wishes to acquire the shares or assets of a Danish target. The advantages and disadvantages of the different acquisition vehicles must be considered case-by-case. The tax value of the interest deductions and the tax treaties entered into by the relevant countries are often decisive in determining the optimal jurisdiction or acquisition vehicle.

Local holding company

A Danish holding company may be used as the acquisition vehicle where the foreign buyer wishes to benefit from the Danish rules on tax consolidation and offset tax losses (due to financing costs) of the acquisition vehicle against taxable profits of other companies in the Danish tax group. The Danish rules restricting interest tax deductions should be analyzed to ensure that financing costs will be deductible for tax purposes and thus can reduce taxable profits in the other operating companies.

A foreign buyer may also consider using a Danish acquisition vehicle to act as a dividend trap. This may be beneficial where the profits are to be reinvested in the Danish or foreign subsidiary since dividends can generally be received tax-exempt if the Danish holding company holds at least 10 percent of the shares in the subsidiary.

Another benefit of using a Danish acquisition vehicle is the relatively low Danish corporate tax rate of 22 percent (2018).

Special attention is advisable where the foreign buyer acquires or incorporates a Danish limited company that is considered transparent for foreign tax purposes (as with US check-the-box rules). For Danish tax purposes, the Danish limited company is also considered as a transparent company and treated as a branch of the foreign company.

As a result, interest paid on loans to the shareholders can be disregarded for Danish tax purposes. It is irrelevant whether the treatment of the Danish limited company as a transparent company is due to foreign legislation or an election by the foreign buyer.

Foreign parent company

A foreign buyer may choose to purchase the target directly instead of using an acquisition vehicle where the tax value of the interest deductions is higher in the jurisdiction of the buyer.

Generally, the Danish WHT rules favor a structure with a foreign holding company because capital gains realized by the foreign acquisition vehicle on a sale of the shares to a third party are not subject to Danish WHT. Additionally, dividends and interest generally are exempt from Danish WHT provided the foreign parent company holds at least 10 percent of the shares and is resident in the EU or in a country that has a tax treaty with Denmark. However, there are exceptions that should be considered in each case.

Non-resident intermediate holding company

Where the foreign buyer would be subject to tax on capital gains and/or dividends received from the target, an intermediate holding company resident in another country with more attractive taxation could be interposed to benefit from tax treaties or EU directives. However, the intermediate holding company would have to be considered as the beneficial owner and meet the requirement on business substance.

As described in 'Recent developments', business substance in foreign intermediate holding companies is currently a high priority area for the Danish tax authorities. It is therefore advisable to pay attention to the substance requirement to avoid the possibility that an intermediate holding company would be disregarded for Danish tax purposes.

Local branch

Rather than a direct acquisition of the shares or assets of a target, a foreign buyer may wish to use a Danish branch of a foreign company as the acquisition vehicle. Shares may be allocated to a Danish PE where the return relates to the Danish branch.

The buyer should ensure that the Danish branch has sufficient operating activity to constitute a PE for Danish tax purposes.

A Danish branch of a foreign company is not a commonly used acquisition vehicle.

In general, the calculation of taxable income generally is the same for a subsidiary as for a branch since both vehicles are considered as taxable entities for Danish tax purposes. Generally, transactions between the Danish branch and the head office should be based on the arm's length principle.

However, special attention must be paid to transactions between a Danish branch and the head office because it is not entirely clear from case law which terms should apply.

Joint venture

Basically, there are three types of joint ventures:

— corporate joint venture, where the joint venture partners hold shares in a Danish company

— unincorporated joint venture, where, for example, the joint venture partners enter into a partnership

— strategic joint venture, where the joint venture partners cooperate on specific strategic objectives.

A corporate joint venture is treated as a corporate entity for Danish tax purposes, while unincorporated and strategic joint ventures are treated as transparent entities for Danish tax purposes.

The choice of joint venture primarily depends on the most beneficial tax positions with regard to, for example, the offset of losses or interest expenses against profits subject to corporate or personal income tax.

Choice of acquisition funding

A buyer using a Danish acquisition vehicle that pays cash consideration for the purchase of a Danish target must decide whether to fund the vehicle with debt, equity or a hybrid instrument. The principles underlying each are discussed below.

Debt

The principal advantage of debt is the potential tax deductibility of interest (see 'Deductibility of interest') as the payment of dividends does not result in a tax deduction.

Where it is decided to use debt, a further decision must be made as to which company should borrow and how the acquisition should be structured.

Tax losses incurred by a Danish acquisition vehicle as a result of tax-deductible financing costs may offset the positive taxable income in the Danish target group, as described in the section on group relief/consolidation. Tax losses incurred by the acquisition vehicle prior to closing are either entity-specific or only available for offset against any taxable income from companies participating in the buyer's tax group prior to closing. Thus, the timing of income and expenses should be considered.

It is possible to introduce or increase leverage in a Danish company after the transaction (debt pushdown). There are various ways to complete the debt pushdown, and the Danish interest limitation rules should be considered. As these rules are complex, local advice should be sought to ensure that a debt pushdown will be effective.

Deductibility of interest

Generally, interest expenses are deductible for corporate income tax purposes. However, the Danish tax system includes a number of rules that may limit the tax-deductibility of interest and other financial expenses. The primary limitations relate to three sets of rules:

1. thin capitalization rules
2. interest ceiling rule
3. earnings before interest and tax (EBIT) rule.

The thin capitalization rules apply to Danish companies and branches with controlled debt, restricting the deductibility of interest expenses. Danish companies or branches may be thinly capitalized where the debt-to-equity ratio exceeds 4:1 at year-end. The assessment is based on fair market value, including non-booked goodwill. The effect of the rules is that any deduction is denied for interest expenses and capital losses on the part of the controlled debt that should be re-characterized as equity to meet the 4:1 debt-to-equity ratio. However, the rules do not apply where the controlled debt does not exceed a threshold of DKK10 million or where the company is able to document that similar financing can be obtained from an independent party.

According to the interest ceiling rule, Danish companies may only deduct interest costs and other net financing expenses to the extent that the expenses do not exceed a standard rate of return of 2.9 percent (2018) on the tax values of certain qualifying assets (mainly operating assets). The limitation applies only to expenses exceeding a threshold of DKK21.3 million. The standard rate of return is adjusted on an annual basis. The interest costs exceeding the interest ceiling are lost permanently and cannot be carried forward. However, capital losses may be offset against capital gains in the following 3 income years.

Under the special EBIT rule, the taxable income before net financial expenses may not be reduced by more than 80 percent by the deduction of net financing expenses after any restrictions due to the thin capitalization and interest ceiling rules. Net financing expenses restricted under the EBIT rule may be carried forward for tax deduction indefinitely.

The three sets of rules must be applied in the above order of priority. Restricted interest costs and capital losses due to thin capitalization are not included in computing limitations under the other two sets of rules.

Unlike the thin capitalization rules, the interest ceiling rule and the EBIT rule apply to all types of debt, both controlled debt and debt to third parties.

These three sets of rules restricting deduction of interest and other financial expenses are very complex. Local advice is recommended where a Danish company's right to deduct interest and other net financing expenses is an issue.

Note also that shareholder loans are covered by the Danish transfer pricing rules. Thus, the terms of the loan must reflect market terms and must be documented.

Withholding tax on interest payments and methods to reduce or eliminate it

Generally, no Danish WHT obligation exists on interest payments on debt to third parties. However, a 22 percent WHT is levied on interest payments to related parties. There are a number of exemptions from the WHT. The most important apply where:

— The foreign company is already taxable on the interest due to a PE in Denmark, that is, where the interest relates to and is received by the PE.

— The receiving company is resident in the EU, the European Economic Area (EEA) or a country with a tax treaty with Denmark. The companies must be at least 25 percent related in terms of shares for at least 12 months during which the interest must be paid.

Certain other exceptions imply that Danish WHT is imposed where the interest income is taxed at a low rate in a foreign jurisdiction.

WHT protection requires that the receiver is considered as the beneficial owner of the interest and not a mere conduit/flow-through company. Otherwise, Danish WHT is levied on the interest payment. As stated earlier, the concept of beneficial owner is a high-priority focus area with the Danish tax authorities — and they generally do not accept stepping-stone arrangements. Several rulings are pending on this issue. It is too soon to draw any definite conclusions until further legal precedence has been established. The question of whether the receiver of the interest payments should be considered as the beneficial owner must be analyzed case-by-case. Local advice should be sought.

The WHT obligation should not apply where the debt is structured as a zero-coupon convertible bond or a similar instrument. (See 'Aggressive approach to preventing tax erosion' earlier in this report.)

Checklist for debt funding

— The use of bank debt may prevent thin capitalization and transfer pricing problems and eliminate the requirement to withhold tax from interest payments. (The use of bank debt does not affect a restriction of the tax deduction of interest under the interest ceiling rule or the EBIT rule).

— Consider the amount of debt funding in order to avoid limitations on the deductibility of interest payments due to the Danish interest limitation rules.

— Consider whether the level of profits would enable tax deduction for interest payments to be effective.

— As a general rule, 22 percent WHT applies to interest paid by a Danish company to a company resident in a country outside the EU that has no tax treaty with Denmark.

Equity

A buyer may use equity to fund its acquisition or to capitalize the target post-acquisition. There is no capital duty on the introduction of new capital into a Danish company or branch (or to a Danish-registered *societas Europaea*), regardless of the nature of the contribution to equity.

There is no Danish WHT on dividends on subsidiary shares or group company shares, that is, where the recipient holds at least 10 percent of the share capital and where the parent company is resident in the EU/EEA or a country that has a tax treaty with Denmark and is considered as the beneficial owner of the distributed dividends. (See 'Recent developments' on the use of intermediate conduit companies).

A Danish WHT of 27 percent (subject to treaty protection) is levied on dividends on portfolio shares, that is, investments of less than 10 percent of the share capital in the Danish company (main rule). The effective taxation of the dividend may be reduced to 22 or 15 percent depending on the circumstances.

The use of equity may be more appropriate than debt in certain circumstances, for example:

— Where the target is loss-making, it may not be possible to obtain immediate tax relief for interest payments.

— A number of restrictions on Danish tax relief for interest may eliminate the principal advantage of using debt.

— There may be non-tax reasons for preferring equity. For example, it may be desirable for a company to have a low debt-to-equity ratio for commercial reasons.

Tax-exempt restructurings

Where the transaction is structured as a share exchange in which the seller receives shares in the purchasing company in exchange for shares in the target company, the seller may rollover the capital gain on the shares in the target company to the new shares. The rollover may be carried out either with or without pre-approval from the tax authorities. Various conditions must be met, depending on whether or not pre-approval is obtained, and local advice should be sought.

No pre-approval is required where the transaction is structured as a tax-exempt merger, but special conditions must be met to obtain the rollover of capital gain for the seller and the tax values for the merging companies.

The Danish rules also allow for tax-exempt demerger and contribution in kind of assets. The reorganizations may be

carried out without pre-approval from the tax authorities in certain circumstances; however, a number of conditions must be satisfied and the shares received in the transaction generally cannot be sold for a period of 3 years. KPMG in Denmark recommends seeking local advice to avoid adverse tax consequences of such transactions.

With the introduction of the Danish GAAR, no exemption is granted for tax-exempt cross-border mergers, demergers, share exchanges and contributions in kind if an arrangement or series of arrangements have been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that is not in accordance with the object or purpose of the EU Parent-Subsidiary Directive, which are not genuine having regard to all relevant facts and circumstances. Furthermore, arrangements or series of arrangements shall be regarded as not genuine to the extent that they are not put into place for valid commercial reasons that reflect the economic reality.

Hybrids

Generally, amounts registered with the Danish Register of Companies are classified as equity. If an amount is not registered as equity, it is characterized as a loan even when it carries a right to participate in profits. Conversely, registered preference shareholders are always considered equity investors even where they are not entitled to participate in excess liquidation proceeds.

A subordinated debt is regarded as share capital by virtue of being subordinated to other creditors. Convertible notes are always regarded as loans until conversion. As a general rule, payments made before conversion are taxed as interest. After conversion, the yield is taxed as a dividend.

The Danish tax qualification of hybrid instruments used by related parties depends on the foreign qualification of the hybrid. Where a hybrid is considered as debt from a Danish tax perspective but is treated as equity from a foreign tax perspective, interest and capital losses on the debt may be treated as dividends for Danish tax purposes.

Discounted securities

The tax treatment of discounted securities issued to third parties depends on the principle applied. Where a mark-to-market principle is applied, the discount accruing over the life of the security is deductible for Danish tax purposes for the issuer and the corresponding profit is taxable for the lender. Where the realization principle is applied, deduction and taxation respectively are deferred until redemption.

Where the issuer and lender are related parties or consolidated for Danish tax purposes, the discount is not deductible for tax purposes if the corresponding profit is tax-exempt.

Deferred settlement

An acquisition may involve an element of deferred consideration, the amount of which can only be determined at a later date on the basis of the post-acquisition performance of the business. The right to receive an unknown future amount is regarded as an asset that must be valued for Danish tax purposes where either the duration of the payments or the actual amount paid each year is uncertain at the time of transfer. The transferring parties are then obliged to calculate a capitalized value of the expected future payments at the time of the transfer. The capitalized values serve as a basis for calculating a preliminary taxable capital gain. The capital gains tax is due at the time of the transfer as in normal taxable transfers.

A recipient of a deferred settlement of the consideration for goodwill and other intangible assets can apply for a tax reprieve until actual payments are received.

Other considerations

Concerns of the seller

The tax position of the seller may greatly influence any transaction, and one of the first concerns is often the tax liability triggered by the transaction.

The taxation of the seller depends on the rules of the country in which the seller is resident and the legal form of the seller. Capital gains realized by a Danish company are generally tax-exempt. Only capital gains on shareholdings of less than 10 percent in listed companies are subject to Danish corporate tax.

Sellers resident outside Denmark are generally not taxable in Denmark on capital gains (except on certain disposals by non-resident companies with a PE in Denmark).

Group relief/consolidation

Danish companies, PEs located in Denmark and Danish immovable property owned by non-resident companies are subject to the Danish rules on mandatory national tax consolidation. Where there is a qualifying group relationship between the entities (i.e. a Danish or foreign parent company holds a controlling influence), a Danish tax group must be formed.

The group consolidation means losses of one company are immediately set off against profits of the other companies. However, losses originating from tax years before the commencement of the tax group may only set off profits in the same company or companies participating in the tax group at the time the loss arose.

All the companies included in the tax group must apply the same financial year, and the rules prescribe which company should be appointed as the administration company for the tax group.

A company's exit from a tax group may give rise to a number of challenges and should be discussed with local tax advisors. Under many share transactions, a target company exits

the seller's tax group during a financial year. In this case, income from the first period must be consolidated in the seller's tax group, and income from the second period must be consolidated in the buyer's tax group. The administrative challenges related to the tax consolidation (and exit from the tax group) should be considered carefully by the seller and the buyer at the time of a transaction and duly reflected in the share purchase agreement.

It is possible for a Danish company to elect international tax consolidation. However, as this implies that all companies with the qualifying relationship must be included in the Danish tax group for a minimum of 10 years. Danish companies within a Danish tax group are jointly and severally liable for corporate tax and WHT.

The joint and several liability ends where a company cease a Danish joint taxation. Accordingly, sold companies do not inherit any liability from other companies in the former Danish tax group.

The remaining part of the selling group remains jointly and severally liable for tax claims against the sold company related to income years before the transfer.

Transfer pricing

Generally, Danish resident companies are subject to the Danish transfer pricing rules. These rules prescribe that all transactions between a Danish company and related companies must satisfy the arm's length principle (i.e. the prices and terms must reflect those that could be applied in a transaction with a third party). In most cases, the company must prepare documentation that supports the basis for the pricing.

The transfer pricing rules are relevant in relation to many aspects of a transaction, such as shareholder loans, inter-company guarantees, cash pool arrangements and transfer of goods, services and assets. The practice of the tax authorities is somewhat unclear, and each case must be examined on its specific facts and circumstances. Caution is advisable when determining the basis of the prices, especially where large amounts are involved.

Dual residency

Under Danish tax law, a company is resident in Denmark where it is registered in Denmark or it is a foreign registered company with an effective place of management in Denmark. There are generally no advantages in seeking to establish a dual resident company.

Foreign investments of a local target company

The original aim of the Danish controlled foreign company (CFC) legislation was to reduce the tax benefits of transferring financial income to low-tax countries. The rules no longer take foreign tax rates into consideration, so they may also be relevant for a Danish parent with a subsidiary in a high-tax country.

The Danish CFC rules apply to a Danish parent company with a controlling influence in a subsidiary whose income is mainly of a financial nature. The effect of the CFC rules is that the income of the subsidiary is apportioned to its Danish parent company and subject to Danish corporate tax. Denmark grants credit for the foreign taxes on the subsidiary's income.

The CFC rules should be considered in many situations, including where:

— the business functions of an entity change

— a transaction could lead to additional financial income in the subsidiary

— a transaction would lead to a significant capital gain

— the tax rate of the subsidiary country is low.

It is not possible to provide an exhaustive list of the situations in which the CFC rules have implications. Each transaction should be examined based on its facts, and local tax advice should be sought.

Company law and accounting

The Danish Companies Act prescribes how Danish companies may be formed, operated, reorganized and dissolved, and is largely based on EU company law directives. In 2009, the Danish company laws were modernized and amended so that both public limited companies (A/S) and private limited companies (ApS) are now regulated in the same act, the Danish Companies Act. (Previously, these two types of companies were regulated by two separate acts.) This allows considerable flexibility, for example, for the payment of the subscribed capital and financial assistance. Company law has significant importance for a buyer investing in a Danish company, as outlined briefly below.

The Danish Companies Act allows for the restructuring of a Danish company through such transactions as mergers, demergers and contributions in kind. Generally, such restructuring may be carried out as tax-exempt transactions, provided certain requirements are met.

A distribution of dividends from a Danish company is subject to the company having sufficient distributable profits, retained earnings, etc., available. Dividends may be distributed at the end of the financial year based on the financial statement or as interim dividends during the financial year. The company's financial situation must be taken into consideration at the time of the declaration of an interim dividend, and certain administrative requirements must be satisfied.

Occasionally, the structuring of a transaction raises financial assistance issues. There have been public discussions on whether dividend distributions from a target company used for the repayment of the buyer's acquisition debt or a merger of the target company and the acquisition vehicle is a violation of the prohibition against self-financing/financial assistance.

Previously, the prohibition against financial assistance stated that it was illegal for a Danish target company (A/S or ApS) to grant direct or indirect financial assistance for the purpose of financing the acquisition of the target company's shares. However, the Danish Companies Act has removed this prohibition by allowing for such assistance within the limitations of the available distributable reserves. Each case must be examined based on its facts, and a number of administrative requirements must be satisfied. Local advice should be sought before providing any such financial assistance.

A number of M&A accounting issues also should be considered. A 'business combination', which is defined under International Financial Reporting Standards (IFRS) as a bringing together of separate entities or businesses into one reporting entity, may be categorized as either a merger or an acquisition.

In essence, a combination is regarded as a merger where it results in a pooling of business interests (i.e. where one company's equity is exchanged for equity in another company) or where shares in a newly incorporated company are issued to the shareholders in the merging companies in exchange for their equity, with both sides receiving little or no consideration in the form of cash or other assets.

In Denmark, non-listed companies can freely choose to adopt either the Danish Accounting Act or IFRS when preparing their accounts. According to Danish generally accepted accounting principles (GAAP), most business combinations are to be accounted for as acquisitions.

Merger accounting is restricted in the Danish Accounting Act to a small number of genuine mergers. One major requirement for a genuine merger is that the fair values of the entities are not significantly different. Further detailed conditions must be met. Merger accounting can always be used for intercompany combinations. Merger accounting is not allowed under IFRS.

Where acquisition accounting is applied, the transaction may give rise to goodwill. The net assets are brought onto the consolidated balance sheet at their fair values, and goodwill arises to the extent that the consideration paid exceeds the aggregate of the values. Where the accounts are prepared according to the Danish Accounting Act, goodwill is amortized through the profit and loss account over its useful economic life. Where IFRS is adopted, the goodwill is not amortized, but its value is subject to impairment tests.

Comparison of asset and share purchases

Advantages of asset purchases

— The purchase price (or a proportion) can be depreciated or amortized for tax purposes.

— A step-up in the cost base for tax purposes is obtained.

— No previous liabilities of the company are inherited.

— No acquisition of a tax liability on retained earnings.

— Possible to acquire only part of a business.

— Greater flexibility in funding options.

— Profitable operations can be absorbed by loss-making companies in the buyer's group, thereby effectively gaining the possibility to use the losses.

Disadvantages of asset purchases

— Possible need to renegotiate supply, employment and technology agreements, and to change stationery.

— A higher capital outlay is usually involved (unless the debts of the business are also assumed).

— May be unattractive to the seller, thereby increasing the price.

— Accounting profits may be affected by the creation of acquisition goodwill.

— Benefit of any losses incurred by the target company remains with the seller.

Advantages of share purchases

— Lower capital outlay (purchase net assets only).

— Likely to be more attractive to the seller, so the price is likely to be lower.

— May benefit from tax losses of the target company.

— May gain benefit of existing supply or technology contracts.

Disadvantages of share purchases

— Acquire unrealized tax liability for depreciation recovery on the difference between market and tax book value of assets.

— No deduction for the purchase price or for underlying goodwill.

— Less flexibility in funding options.

— Losses incurred by any companies in the buyer's group in years prior to the acquisition of the target cannot be offset against any profits made by the target company.

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Finland

Introduction

The Finnish tax environment has changed fundamentally in recent years, and companies and prospective investors are expected to face even more changes on the upcoming implementation of the Anti-Tax Avoidance Directive (ATAD), which takes effect on 1 January 2019. In previous years, the Finnish government has implemented a variety of rules to prevent erosion of Finnish tax base such as earnings-stripping rules.

This section covers these developments and considers the following three fundamental questions facing prospective buyers:

— Should they acquire target's shares or assets?

— What should be used as the acquisition vehicle?

— How should they finance the acquisition vehicle?

This report also addresses other considerations that prospective buyers should take into account, such as company law and group contributions. This report concludes with a short summary of advantages and disadvantages of both, share and asset purchases.

Recent developments

Implementation of ATAD will present major changes to the Finnish tax law, especially the earnings-stripping rules that govern the deductibility of interest costs. Among these changes, the deductibility of interest paid on external loans will be limited, and the interest deduction limitation rules will be extended to companies that are taxed based on Finnish Income Tax Act (e.g. mutual real estate companies) and financial institutions. It seems that Finland will implement the measures of ATAD more strictly than the directive requires.

Merger

A merger is a tax-neutral way to combine Finnish companies. The following rules pursuant to the Business Income Tax Act apply for tax-neutral mergers:

— The transferring company is deemed not to be dissolved for the purposes of taxation.

— The expenses of the transferring company are deducted in the recipient company as they would have been deducted in the transferring company; the maximum depreciations (for the year of the merger) of the recipient company are reduced by the depreciation allowed in the taxation of the transferring company for that year.

— A loss resulting from a merger (i.e. the difference between the acquisition cost of shares and the value of net assets transferred) is not a deductible expense and a gain is not taxable income.

— The recipient company and the transferring company are treated as separate taxpayers until the merger is complete.

— The exchange of the shares in the absorbed company for shares in the recipient company is not treated as a taxable event for shareholders of the absorbed company.

— Cash may be used as consideration, but it must not exceed 10 percent of the nominal value of the new shares issued by the recipient company; the transaction is deemed to be a taxable event for shareholders to the extent that cash compensation is used.

— The deductible acquisition cost of the new shares received as a consideration by the shareholders of the transferring company is equal to the acquisition cost of the shares in the transferring company.

Tax loss carry-forwards may be forfeited permanently in certain situations. The recipient company or its shareholders, or the recipient company and its shareholders together, must have held more than 50 percent of the shares of the merging company at the start of the year in which the tax loss accrued in order to retain the right to carry forward its losses and use its tax surpluses.

Pursuant to the Transfer Tax Act, a merger is not subject to transfer tax. However, where cash is used, the cash consideration is subject to transfer tax of 1.6 or 2 percent (even where the cash consideration does not exceed 10 percent of the nominal value, or in the absence of a nominal value, of the accounting par value of the newly issued or existing shares given by the recipient company).

Where the cash consideration does exceed 10 percent of the nominal value or accounting par value of the issued shares, the merger is not considered tax-neutral. In case law, the tax effects of a taxable merger are equivalent to liquidation; the merging entity is deemed to be liquidated for tax purposes. The effects of liquidation are discussed later in this report.

Finland

Finland has implemented the provisions of the European Union (EU) Merger Directive on mergers between companies in different member states. Thus, Finnish tax law regulating mergers applies to mergers between companies resident in two or more member states. Finnish company law was amended, as of 31 December 2007, to recognize cross-border mergers, so these mergers are also practical from a tax viewpoint.

Other tax-neutral transactions cover complete and partial demergers, transfers of assets and share swaps under certain preconditions that should be analyzed case-by-case. Certain clawback issues may be triggered, for example, in cross-border transactions.

Asset purchase or share purchase

An acquisition in Finland usually takes the form of a purchase of the shares of a company, rather than its business and assets, because capital gains on the sale of shares may be exempt in certain circumstances. From a tax perspective, the capital gains consequences and possible double taxation on extracting the sales proceeds are likely to make asset acquisitions less attractive for the seller. However, the benefits of assets acquisitions for the buyer should not be ignored, particularly given that purchased goodwill is tax-deductible. Some of the tax considerations relevant to each method are discussed below.

Purchase of assets

A purchase of assets usually results in an increase in the base cost of those assets, although this increase is likely to be taxable for the seller. In addition, historical tax liabilities generally remain with the selling company and are not transferred with the assets.

Purchase price

For tax purposes, it is necessary to apportion the total consideration among the assets acquired. It is generally advisable for the purchase agreement to specify the allocation, which is normally acceptable for tax purposes, provided it is commercially justifiable.

Goodwill

The Finnish Business Income Tax Act stipulates that the purchase price must be allocated to the individual assets up to their fair market value. The excess purchase price is considered goodwill. Consequently, the buyer receives a step-up in the tax base of the assets and can deduct the goodwill for tax purposes. The goodwill must be capitalized and amortized over its economic life up to a maximum of 10 years.

Depreciation

Acquisition costs of patents, copyrights and trademarks, etc., are depreciated by the straight-line method over 10 years, or, where the taxpayer can show that the likely economic lifetime of the asset is shorter, over that period.

Expenses incurred in acquiring fixed assets are deductible through depreciation. The acquisition cost of the taxpayer's entire stock of machinery and equipment is written off annually as a single item using the declining-balance method. Under this method, the depreciation base consists of the net book value of all such assets plus the acquisition value of assets introduced during the tax year, less any sales proceeds, insurance compensation and the like received for assets sold, damaged or lost during the tax year. The maximum annual depreciation is 25 percent of this base. Where the taxpayer can show that the current value of these assets is less than the depreciation base reduced by the full 25 percent, the taxpayer is entitled to such additional depreciation as is necessary to reduce the depreciation base to the current value.

Where the depreciation base for machinery and equipment is negative, the excess is treated as current taxable income.

As an exception to the general rule, machinery and equipment with an economic life of 3 years or less can be either written off in full in the year of acquisition or depreciated along with other machinery and equipment.

Buildings and other constructions are also depreciated by the declining-balance method. Each building must be depreciated as a separate item. Maximum rates of depreciation range from 4 to 20 percent, depending on the use of the building.

Where a taxpayer can show that the current value of the building is less than its book value, the taxpayer is entitled to additional depreciation. Large repair costs can be either deducted as a cost immediately or included in the depreciation base of the building.

The depreciation rate for industrial buildings, power stations, workshops, warehouses, stores and similar buildings is 7 percent. The rate for homes, offices and other similar buildings is 4 percent.

Tax attributes

Tax losses are not transferred on an asset acquisition. They remain with the seller. The seller can utilize these tax losses against any capital gain realized on the sale of the assets.

Value added tax

All goods and services, unless expressly excluded, are subject to value added tax (VAT). The standard rate of VAT is 24 percent. As an EU member state, Finland has adopted VAT legislation in line with the EU VAT Directive.

VAT is not payable on the sale or other supply of goods and services where the sale or supply takes place in connection with the transfer of an entire business enterprise, or part of it, to a transferee carrying on the business and using the goods and services for a purpose that entitles the transferee to the deduction. Therefore, a transaction through an asset deal under these circumstances is not subject to tax.

Stamp duty and stamp duty land tax

A so-called 'transfer tax' of 1.6 percent is due on the fair market value of Finnish securities, including shares of Finnish companies, and 4 percent on the real estate transferred in the asset deal. The transfer tax is 2 percent on transfers of shares in real estate companies or housing companies. The transfer tax base is not only the equity value but also other payments (e.g. shareholder loan repayments) to the seller or its affiliates. Finnish tax authorities usually accept the purchase price allocation agreed by the seller and the buyer as an indication of the fair market value.

Purchase of shares

The purchase of a target company's shares does not result in an increase in the base cost of that company's underlying assets. There is no deduction for the goodwill (i.e. the difference between underlying net asset values and consideration).

Tax indemnities and warranties

In a share acquisition, the buyer is taking over the target company together with all related liabilities, including contingent liabilities. The buyer, therefore, normally requires more extensive indemnities and warranties than in the case of an asset acquisition.

Where significant sums are at issue, it is customary for the buyer to initiate a due diligence exercise, which normally incorporates an analysis of the target's tax affairs.

Tax losses

Taxable income or loss is calculated separately for the different sources of income (i.e. business income, agricultural income and other (personal) income). Tax losses may be carried forward for 10 years and set off against income from the same source in which the loss was incurred. Losses are deducted in the order incurred.

Where more than 50 percent of the shares of a company have changed ownership, the right to carry forward tax losses is forfeited unless the regional tax office grants a dispensation. Indirect ownership changes are taken into consideration where there has been a change in the ownership of a shareholder that owns at least 20 percent of the shares in the company in question. There are no special provisions allowing the losses of one company in a group to be deducted from the profits of other companies in the same group. However, group contributions are tax-deductible in certain conditions, which can be useful in utilizing tax losses within a group.

In 2011, the Finnish Supreme Administrative Court asked the European Court of Justice (ECJ) to determine whether the Finnish exemption system concerning tax losses and changes in the ownership of companies with tax losses could constitute state aid, which is incompatible with the EU law. The ECJ gave its judgment in 2013, but did not take a clear position on whether the exemption regime constitutes state aid. However, the ECJ has stated that the exemption regime should be classified as existing aid where it happened to constitute state aid. Thus, the Finnish Tax Administration should adhere to the tax laws in force and can continue to grant dispensations. However, the European Commission may investigate the compatibility of the dispensation regime with the EU law sometime in the future.

In the case of a merger, the acquiring company or its shareholders or both of them together must have held more than 50 percent of the shares of the merging company by the beginning of the loss-making year to retain the right to carry forward tax losses. No dispensation can be applied for in relation to tax losses forfeited in mergers.

Crystallization of tax charges

Capital gains taxation for the transferor can be deferred where preconditions for the exchange of shares are fulfilled. Where an acquisition is effected by the purchase of shares in exchange for the issue to the seller of new shares in the buyer, the gain may be rolled over into the new shares, thus enabling the seller to defer the Finnish capital gains tax liability. Additional conditions for the tax-neutrality are that cash compensation cannot be more than 10 percent of the issued shares' nominal value (or accounting par value in the absence of nominal value) and that the buyer acquires more than 50 percent of the voting power of the target. It is possible to obtain clearance in advance from the Finnish tax authorities that the exchange of shares transaction will be considered tax-neutral (i.e. that the tax-free rollover is not denied). Capital gains taxation is realized to the extent cash compensation is paid to the transferor.

Pre-sale dividend

In certain circumstances, the seller may prefer to realize part of the value of their investment as income by means of a pre-sale dividend. The rationale here is that the dividend may lead to lower Finnish tax but reduces the proceeds of sale and thus the gain on sale, which may be subject to a higher rate of tax. The dividend also reduces the consideration given for the shares in a Finnish company, so it could lower the amount of the transfer tax payable, which benefits the buyer, depending on timing of the dividend distribution. The position is not straightforward, and each case must be examined on its facts.

Stamp duty

A so-called 'transfer tax' is payable at the rate of 1.6 or 2 percent on the value of the consideration given for shares and certain other payments that benefit the seller or its affiliates, provided either the seller or buyer is a Finnish resident individual or company. Where both the seller and buyer are not Finnish resident, no Finnish transfer tax is due unless the objects of the transfer are shares in Finnish real estate or housing company. Special rules may apply to Finnish branches of certain foreign financial institutions.

Tax clearances

It is possible to obtain a clearance from the tax authorities giving assurance that a potential target company has no arrears of tax within the last 12 months preceding the date of the tax certificate. The standard certificate relies on tax return filings and payments of the target company. It does not state whether or not the target is involved in a tax dispute or whether the information on the tax returns was correct.

Choice of acquisition vehicle

Several potential acquisition vehicles are available to a foreign buyer, and tax factors often influence the choice. There is no capital duty on the introduction of new capital to a Finnish company or branch (or to a Finnish-registered SE (Societas Europaea, which is a European company)).

Finland holding company

There are no special rules for holding companies in Finland. Companies may qualify for an exemption from tax on capital gains in respect of gains realized on the disposal of shares where the seller has owned at least 10 percent of the share capital of the target company for at least 12 months prior to the disposal. Additionally, the shares must have been fixed assets of the seller.

The participation exemption does not apply where the seller is a company that carries on private equity or venture capital activities (word-for-word translation from Finnish is 'capital investment activities'). The exemption also does not apply where the target company is a real estate company or other company, the activities of which consist of owning and managing real estate.

The definition of 'private equity or venture capital activities' has been left open in the law. Based on a statement of the Finance Committee of the Parliament, private equity and venture capital houses seek, finance and promote high-risk enterprises that may have difficulty obtaining financing from other sources. The purpose of the private equity/venture capital investor is to develop the activities of the company and contribute to the company's value. The investor is not a permanent owner but intends to realize its shareholding during a stated time period. Private equity and venture capital investors typically own a minority of the company's share capital and do not normally receive any return on their investment before the disposal of the shares.

Although the above statement on private equity or venture capital activities brings some clarity, a number of issues remain open and the application of the participation exemption to private equity or venture capital investments is unclear. According to recent Supreme Administrative Court decisions, private equity-owned holding companies, incorporated for a transaction, may be considered as capital investors not entitled to the capital gains exemption.

Where the participation exemption is applicable, capital losses and write-downs in the value of the subsidiary shares are not tax-deductible. Unrealized share write-downs also are non-deductible for capital investors.

Interest costs related to the acquisition of shares are tax-deductible, provided that the earnings-stripping rules do not apply and the interest rate is arm's length. It is possible to deduct the interest cost in the acquisition vehicle against the profits of the target company, provided a group contribution is allowable between the target and the acquisition vehicle (see 'Group relief/consolidation' below). A Finnish branch of a foreign company can also grant or receive a group contribution.

Restrictions on interest cost deductions took effect as of 1 January 2013 and apply for financial periods that end on or after 1 January 2014. (See 'Choice of acquisition funding' below.)

Foreign parent company

The foreign buyer may choose to make the acquisition itself, perhaps to shelter its own taxable profits with the financing costs. This does not necessarily cause any tax problems because Finland does not tax the gains of non-residents disposing of Finnish shares (unless the company's main activity is to possess Finnish real estate). Finland levies withholding tax (WHT) of 30 percent on dividends. A reduced rate of 20 percent may be applied on dividends to certain foreign corporations. Further, the WHT is often reduced in the tax treaties concluded by Finland. There is no WHT on dividends paid to parent companies resident in the EU. Finland does not levy WHT on interest (subject to some minor exceptions).

Non-resident intermediate holding company

Finland has a comprehensive tax treaty network with more than 60 countries, including all the industrialized countries and almost all the important developing countries.

Finland branch

A non-resident company normally carries on business in Finland through a Finnish corporation (subsidiary) or registered branch. The corporate tax rate of 20 percent applies to both subsidiaries and branches.

The calculation of taxable income is basically the same for a subsidiary as for a branch. Both must base their intercompany transactions on the arm's length principle, and each is considered to be an independent entity for tax purposes. However, a reasonable allocation of executive and general administrative expenses to the branch is allowed. A branch is not allowed to deduct interest on loans from the head office, but the profits of a branch may be remitted to the head office free of WHT.

The advantages and disadvantages of different vehicles must be considered case-by-case.

Joint venture

No special tax legislation applies to joint ventures.

Choice of acquisition funding

A buyer using a Finnish acquisition vehicle to carry out an acquisition for cash needs to decide whether to fund the vehicle with debt, equity or a hybrid instrument that combines the characteristics of both. The principles underlying these approaches are discussed below.

Debt

The principal advantage of debt is the potential tax-deductibility of interest (see deductibility of interest), as the payment of a dividend does not give rise to a tax deduction. Another potential advantage of debt is the deductibility of expenses, such as guarantee fees and bank fees, in computing taxable income from business activities.

Where it is decided to use debt, a further decision must be made as to which company should borrow and how the acquisition should be structured. To minimize the cost of debt, there must be sufficient taxable profits against which interest payments can be made. The following comments assume the buyer wishes to offset the interest payments against the Finnish target's taxable profits. Consider also whether relief would be available at a higher rate in another jurisdiction.

Typically, a Finnish company is used as the acquisition vehicle, funding the purchase with debt either from a related party or directly from a bank. Provided that at least 90 percent of the target's share capital is acquired, it should be possible to offset interest paid against Finnish taxable profits arising in the target group from the beginning of fiscal year following the acquisition.

Generally, it is safer to introduce debt financing at the time of the acquisition than after because the Finnish tax authorities have recently tried to challenge post-acquisition debt pushdowns. Further, the Finnish tax authorities have challenged intragroup reorganizations driven by new debt allocation.

There is no specific legislation denying post-acquisition debt push-down. Based on recent case law, debt push-down arrangements can be deemed as tax avoidance under certain circumstances. Careful tax planning is required, and local advice should be sought.

Deductibility of interest

The earnings-stripping rules apply for financial years that end on or after 1 January 2014. Limitations apply to Finnish corporations and general and limited partnerships carrying on business activities; thus, the limitations do not apply to, for example, most real estate companies that are not treated for tax purposes as companies carrying on business activities. However, this will change on 1 January 2019, when the ATAD is effective and the earnings-stripping rules begin applying to these companies as well.

Limitations also apply to foreign corporations in their Finnish taxation (i.e. to Finnish permanent establishments of foreign entities). Both domestic and cross-border interest expenses are subject to the limitations.

The limitations are based on the debtor taxpayer's taxable business profits before tax earnings before income tax, depreciation and amortization (EBITDA). Received and paid group contributions are taken into account in calculating the taxable business income, but carried forward tax losses are not deducted.

Interest expenses are fully deductible corresponding to the received interest income. Interest cost exceeding the received interest income is deductible insofar as it represents at maximum 25 percent of the tax EBITDA. Interest cost exceeding the 25 percent threshold is not tax-deductible; however, the non-deductible interest expense is limited to the net interest expense paid to associated companies only. Where no interest is paid to associated companies, the tax-deductibility of the interest is not limited. This will change on 1 January 2019, when external loans become subject to limitation rules as well. It appears that Finland will keep the current tax EBITDA level at 25 percent, even though ATAD allows 30 percent.

The determination of 'associated company' corresponds to the current legislation on transfer pricing adjustments. There are two exceptions (safe harbors):

1. Where the net interest expense is at maximum 500,000 euros (EUR) (including net interest expenses to both associated companies and third-party creditors), the limitations are not applied. It seems likely that the 'de minimis' threshold will be EUR3,000,000 for net interest expenses resulting from external loans in 2019, when interest expenses resulting from external loans become subject to limitation rules. The threshold for interest expenses resulting from intragroup loans will remain EUR500,000.
2. The limitation rules are not applied if the taxpayer can show that the ratio of equity to total assets (according to International Financial Reporting Standards (IFRS) or entity accounts under Finnish generally accepted accounting principles (GAAP)) is equal to or higher than the relevant ratio in the consolidated financial statements (comparison is made primarily to IFRS; local GAAP in EU/European Economic Area (EEA) or similar GAAPs, such as US GAAP, should be allowed) at the level of the ultimate parent of the taxpayer's group. Note that in recent Supreme Administrative Court rulings, the taxpayer has not been able to present an acceptable group level where consolidated financial statements could be made. Furthermore, this safe harbor rule will likely be excluded altogether from the legislation taking effect on 1 January 2019.

The limitations are not applied to finance, insurance or pension institutions. The limitations described above are likely to apply to finance institutions as well beginning from 2019.

The limitations also cover so-called 'back-to-back financing' situations where the loan is obtained from third-party financier that has a collateral/guarantee from another associated company. However, such arrangements contaminate the third-party financing only where the guarantee is a corresponding receivable (e.g. deposit).

Publicly issued bonds and cash pooling arrangement are usually not subject to interest limitations. The limitations do not signify a reclassification of the non-deductible interest expense to, for example, dividends. Thus, corresponding interest income is regarded as fully taxable for the recipient.

The non-deductible interest expense of a certain fiscal year accumulates and is deductible from the business profits of the following fiscal years, taking into account the above limitations for each fiscal year. There is no time limit for the future deductibility, and changes of ownership do not affect the carry-forward of the deductions.

The limitations have a 'lex specialis' status. In practice, this means that the tax deductibility of interest expenses can also be limited or denied based on the arm's length principle and general tax avoidance clause, where applicable.

No grandfathering is available. The limitations apply to interest expenses on existing intragroup debts that were in place before the beginning of financial year that ended in 2014.

Withholding tax on debt and methods to reduce or eliminate it

There is no WHT on interest in Finland (subject to minor exceptions).

Checklist for debt funding

- The effects of earnings-stripping rules and use of group contributions should be considered case-by-case.
- Consider whether and to what extent the level of profits in Finnish group companies would enable tax-deductibility of the interest expenses.
- Analyze the timing of the group contribution because deductibility is only possible from the beginning of the fiscal year following the acquisition.
- Analyze the arm's length nature of the terms of loans granted by associated companies.
- All current financing structures should be re-evaluated and possibly adjusted in light of the upcoming implementation of ATAD.

Equity

A buyer may use equity to fund its acquisition, possibly by issuing shares to the seller in satisfaction of the consideration or by raising funds through a seller placing. Further, the buyer may wish to capitalize the target post-acquisition.

Finland does not impose capital duty on contributions to equity, and no stamp duty or Finnish transfer tax applies on new share issues.

Hybrids

According to guidelines published by the Finnish National Board of Taxes, capital/subordinated loans fulfilling the conditions set out in the Finnish Companies Act are considered as debt for Finnish tax purposes. Thus, the interest on such debt and on profit-participating loans is tax-deductible.

Deferred settlement

An acquisition often involves an element of deferred consideration, the amount of which can only be determined at a later date on the basis of the business's post-acquisition performance. The right to receive an unknown future amount must be estimated based on the information available at the time of the acquisition and considered as part of compensation. Where it turns out later that the estimate was not correct, the estimate must be corrected by notifying the tax authorities of the additional income or filing an appeal for a reduction of taxable income for the acquisition year.

Other considerations

Concerns of the seller

The tax position of the seller can be expected to significantly influence any transaction. In certain circumstances, the seller may prefer to realize part of the value of their investment as income by means of a pre-sale dividend. The rationale here is that the dividend may be subject to low Finnish tax but reduces the proceeds of sale and thus the gain on sale, which may be subject to a higher cash tax. The dividend also reduces the consideration given for the shares in a Finnish company and thus the amount of the transfer tax payable, which could benefit the buyer, depending, for example, on timing of the dividend distribution. The position is not straightforward, however. Each case must be examined on its facts.

Finland does not tax gains of non-residents (except on disposals of real estate and companies whose main assets are real estate and on certain disposals by non-resident companies with a permanent establishment in Finland).

Company law and accounting

The Finnish Companies Act 2006 is a modern and comprehensive law that provides plenty of scope for reorganizations. For example, from the Finnish company law perspective, cross-border mergers and triangular mergers are possible.

It is possible for a Finnish company to follow IFRS in its single company accounts. Few companies have used this option because the accounting is the basis for tax returns of a Finnish company, and IFRS and taxation were not reconciled. However, as of 2009, certain changes were made to the

Finnish tax legislation that enable a tax-neutral merger, transfer of assets or demerger even where assets need to be valued at fair market value in accounting in accordance with IFRS. Still, IFRS is not beneficial, for example, for companies that are willing to grant or receive group contributions or have accelerated depreciation for tax purposes.

Another important feature of Finnish company law concerns the ability to pay dividends. Distribution of profit may be made only out of a company's distributable reserves.

Finally, a common issue on transaction structuring arises from the provisions concerning financial assistance. Broadly, these provisions say that it is illegal for a company to give financial assistance, directly or indirectly, for the purpose of acquiring its own or its parent company's shares.

Group relief/consolidation

Under the Business Income Tax Act, corporations are taxed separately and no consolidated tax returns are accepted. However, arrangements similar to group taxation are possible for tax-deductible group contributions for limited (liability) companies under certain conditions.

Group contributions (other than capital contributions, which are not deductible) can be credited between domestic companies from business income (not relating to the banking or insurance industries), where the contribution is not otherwise deductible from business income. To qualify, both companies must be resident in Finland and there must be at least 90 percent ownership, direct or indirect, from the beginning of the tax year. Group contributions can be credited in both directions, from a parent company to a subsidiary and vice versa, as well as horizontally between sister companies. The criteria for indirect ownership can be fulfilled through a foreign company on the basis of the non-discrimination clause in the tax treaty with the country involved. Where a Finnish or non-Finnish company owns at least 90 percent of its Finnish subsidiaries, a group contribution can be effected between these subsidiaries, provided the other conditions discussed above are met.

The granted group contributions may not exceed the taxable income of the contributing company in the tax year. The contributing company must formally make the decision during the tax year in which the contribution is granted, but the actual payment can be made only when financial statement has been adopted by general meeting. The group contribution is tax-deductible only where the corresponding deduction is made in the books of the contributing company and where the receiving company books the contribution as its (taxable) income during the (tax) year in which it is deducted by the contributing company. At least a 90 percent group relationship must have prevailed during the entire fiscal year, and the financial years of the companies must end on the same day.

According to case law, a Finnish branch of a company resident in the EU may also receive and grant group contributions.

Transfer pricing

Arm's length pricing must be followed in all intragroup transactions, including between Finnish group companies.

Dual residency

Group contributions granted by a Finnish group company to a dual resident company are not tax-deductible, so the losses of a dual resident company cannot be offset against profits of other Finnish group companies.

Foreign investments of a Finland target company

Finland's controlled foreign company (CFC) legislation is designed to prevent Finnish companies from accumulating profits offshore in low-tax countries. Unless the offshore subsidiary is carrying on certain acceptable activities or meets other specified conditions, its profits are apportioned to its Finnish parent and subject to tax. Broadly speaking, subsidiaries situated in tax treaty countries or in the EU are not usually considered as CFCs.

Comparison of asset and share purchases

Advantages of asset purchases

— Goodwill is tax-deductible for the buyer.

— Step-up in the cost base for tax purposes is obtained.

— Possible to set off capital gain on assets against tax losses in the seller company.

— No previous liabilities of the company are inherited. After the asset deal, the seller company is still legally responsible for the company's liabilities, such as taxes.

— Possible to acquire only part of a business.

— Profitable operations can be absorbed by loss-making companies in the acquirer's group, thereby effectively gaining the ability to use the losses.

Disadvantages of asset purchases

— Possible need to renegotiate various types of external agreements.

— A higher capital outlay is usually involved (unless debts of the business are also assumed).

— Where the seller company does not have any tax losses, the capital gain is taxable at the 20 percent corporate tax rate. Thus, it may be unattractive to the seller, thereby increasing the price.

— Tax loss carry forwards and other tax attributes remain in the seller company (the buyer cannot take any advantage of the tax attributes).

— Transfer tax of 1.6 or 2 percent is due on the fair market value of the shares of the Finnish companies or real estate (4 percent) included in the assets. The buyer is liable for the tax.

Advantages of share purchases

— There is a lower capital outlay (purchase net assets only).

— Likely more attractive to the seller due to the participation exemption, so the price is likely to be lower.

— In an ownership change of more than 50 percent, the tax losses are forfeited. However, a Finnish company subject to the change of ownership may apply to the tax authorities for permission to use these tax attributes.

— Possible to benefit from existing external contracts.

Disadvantages of share purchases

— No tax deduction for the goodwill element in the purchase price.

— Buyer inherits liability for any claims or previous liabilities of the acquired entity.

— Where either the buyer or the seller is a Finnish resident, the purchase of Finnish shares is subject to transfer tax of 1.6 or 2 percent; where shares in real estate companies and housing companies are transferred, transfer tax of 2 percent is payable regardless the residency of the parties.

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France

Introduction

To summarize the French rules applicable to cross-border mergers and acquisitions (M&A), this report addresses three fundamental decisions facing a prospective buyer.

— What should be acquired: the target's shares or its assets?

— What will be the acquisition vehicle?

— How should the acquisition vehicle be financed?

Tax is, of course, only one piece of transaction structuring. Company law governs the legal form of a transaction, and accounting issues are also highly relevant when selecting the optimal structure. These areas are outside of the scope of the report, but some of the key points that arise when planning the steps in a transaction plan are summarized later in the report.

Recent developments

The latest major French reforms in the area of cross-border transactions are described below.

3 percent tax on distributions found unconstitutional

— In decisions of the European Court of Justice (ECJ) on 17 May 2017) and the Constitutional Court on 6 October 2017, the 3 percent tax on distributions was found to be unconstitutional, opening opportunities to claim for refunds for the tax, subject to conditions and limitations.

— The Finance Act for 2018 formally repealed the tax, as of 1 January 2018.

Exceptional corporate income tax surtaxes

— Exceptional surtaxes on corporate income tax (CIT) apply only once for fiscal years (FY) ending between 31 December 2017 and 30 December 2018. These taxes apply to large companies only (i.e. companies with a sales turnover exceeding 1 billion euros (EUR). For the head of a French tax consolidated group, the sales turnover to be considered is the aggregate sales turnover of each entity that is a member of the tax group.

— A first surtax of 15 percent of the CIT due for the FY (before offsetting of any tax credits) applies to companies with a turnover exceeding EUR1 billion.

— Companies with a turnover of at least EUR3 billion are subject to a second 15 percent surtax.

— The payment of these exceptional, additional contributions must be made by the CIT balance due date. The law provides for an advance payment of 95 percent of the exceptional surtaxes due, to be paid by the last CIT installment due date.

— The contributions cannot be offset against available tax credits, tax reductions or any other tax receivables.

Standard corporate income tax rate reduced

— The standard CIT rate is 33.33 percent. This rate will be progressively reduced to 25 percent by 2022 as follows:

  — 2018: 28 percent on the profits up to EUR500,000 and 33.33 percent on profits over this amount

  — 2019: 28 percent on the profits up to EUR500,000 and 31 percent on profits over this amount

  — 2020: 28 percent

  — 2021: 26.5 percent

  — 2022: 25 percent.

— The 3.3 percent social surcharge (which applies on the fraction of CIT above EUR763,000) remains in place. A lower CIT rate of 5 percent can benefit smaller enterprises, subject to conditions and limitations.

Carrez amendment modified

— The provisions of the Carrez amendment have been modified to bring them in line with EU legislation.

— The Carrez amendment disallows the deduction of interest expenses relating to the acquisition of qualifying participations (*titres de participation*) that are not managed by the company holding them or by a company established in France and belonging to the same economic group. As of 1 January 2018, companies established in the European Union (EU) or a member state of the European Economic Area (EEA) (which has concluded with France a tax treaty providing for administrative assistance) are 'assimilated' to companies

established in France (meaning that the French company can be managed by a company established in France, the EU or the EEA under certain conditions).

Tax deferral for mergers and similar transactions

— The deferral regime for mergers and similar transactions was amended, partly in light of the *ECJ's Euro Park Service* decision (Case C-14/16).

— For transactions executed on or after 1 January 2018, the most significant changes are as follows:

  — For cross-border transactions, pre-approval from the tax administration is no longer required. However, the deferral regime applies only if the assets transferred by the French absorbed company to the foreign absorbing company are allocated to a French permanent establishment and certain reporting obligations are complied.

  — In case of demerger or spin-off (partial business transfer), the 3-year holding requirement (which applies to the shares received in consideration of the contribution) is no longer applicable, except when assets and liabilities contributed do not qualify as a full branch of activity (in which case the required pre-approval from the tax authorities is subject to a 3-year holding commitment, among other things).

  — For spin-offs (partial business transfers), pre-approval is no longer required for distributions of shares received in consideration for the contribution to the contributor's shareholders (proportional), subject to conditions and limitations (in particular, the distribution must occur within 1 year following the contribution).

  — The definition of 'full branch of activities' is extended to the contribution of shares reinforcing an existing majority stake (more than 50 percent) in the company receiving the contribution.

  — The anti-abuse clause in Article 15.1-a of EU the Merger Directive is introduced in French law. Under this clause, the tax deferral does not apply where it appears that the main objective, or one of the main objectives, of a restructuring transaction, is fraud or tax avoidance (unless there is evidence to the contrary) when the transaction is not carried out for sound business reasons, such as the restructuring or rationalization of the activities of the participating companies).

Contract law reform

— Ordinance no. 2016-131 of 10 February 2016, which reforms contract law, the general regime and the proof of obligations, entered into force on 1 October 2016, introducing new articles into the French Civil Code (Articles 1100 to 1386-1).

— This reform primarily codifies numerous previous jurisprudential solutions and introduces new concepts (e.g. the legal obligation of confidentiality, unpredictability).

— This reform affects pre-contractual negotiations and drafting of contracts for M&A transactions, particularly the drafting and execution of unilateral promises to sell or purchase. The judge's power of interpretation has also been strengthened.

Asset purchase or share purchase

Although an asset purchase may be considered as a more flexible funding option, a share purchase can be more attractive, notably regarding the amount of registration tax and the right to transfer tax losses of the target company. Some tax considerations relevant to each method are discussed later in this report.

Purchase of assets

Transfers between associated parties must normally be made at market value, although market value, being an economic rather than a tax concept, is not defined in the law. The market price is generally the price that an ordinary buyer would agree to pay.

Where the assets are transferred at a price that is lower or higher than their market value, the difference can be qualified as a deemed distribution, subject to withholding tax (WHT) where one of the parties is a non-resident.

Within a tax-consolidated group, if assets are transferred between members at a price that is lower or higher than the assets' market value, the difference constitutes an indirect subsidy, which is only partly neutralized at the level of the tax-consolidated results (following *Corbfi* case law). However, such indirect subsidies (to the extent that they were initially neutralized) must be de-neutralized in the group-taxable results of the FY during which either the company that grants or the company that benefits from the indirect subsidy leaves the tax group or the tax-consolidation group ceases to exist. This can result in an effective tax impact in certain cases.

Goodwill

Under French tax rules, goodwill, which is considered an intangible asset, generally cannot be amortized except by the creation of a provision, subject to strict conditions.

The value of the goodwill is included in the net worth of the company. If goodwill is transferred, it must be included in the recipient company's accounts.

Depreciation

Most tangible assets may be depreciated for tax purposes, the major exception being land. Rates of depreciation vary depending on the asset. Higher rates are allowed for plant and machinery used in two-or three-shift manufacturing and for assets subject to substantial corrosion or abrasion.

As of 1 January 2005, new accounting rules apply to depreciation. Based on International Financial Reporting Standards (IFRS), component accounting is used for the separate components of an asset, and depreciation is booked component-by-component.

Typical rates are as follows:

— motor vehicles: 20 percent, straight-line method

— plant and machinery: 10 to 20 percent, straight-line method

— buildings: 2 to 5 percent, straight-line method.

Intangible assets, such as goodwill and securities, may not generally be amortized, but, under certain circumstances, they may be depreciated by way of provisions. However, the acquisition costs of technical processes, patents, patterns and knowhow are usually depreciated over the length of their legal or contractual life.

Under French tax rules, patents may be depreciated over a period that is shorter than their period of legal protection but not less than 5 years.

In order to encourage investment in the industrial production, companies can deduct from their taxable income a sum equal to 40 percent of the original cost of eligible assets (except financial charges) used for their activity when such assets are manufactured or purchased between 15 April 2015 and 14 April 2017. This measure also benefits to companies renting qualifying assets under a leasing contract, or a rental contract with a purchase option, concluded during that period of time. Thus, instead of deducting 100 percent, companies may deduct 140 percent of the value of the purchased, manufactured or rented assets. The measure has been extended to optic fiber equipment, heavy trucks and robots acquired or manufactured between 1 January 2016 and 14 April 2017.

Value added tax

In the absence of special rules, the standard valued added tax (VAT) rate is 20 percent.

A VAT exemption is applicable where the sale qualifies as a transfer of universality or part thereof within the meaning of French and EU law, such as a transfer of a business.

On the transfer of a business, the exemption applies to the disposal, subject to payment, of all the assets constituting the business (i.e. intangible and tangible assets excluding real estate).

The effective transfer of the clientele is necessary to qualify for such VAT exemption. The disposal of an isolated element would then be subject to VAT, unless the element in question is the clientele or real estate, in which case the disposal is usually subject to the transfer tax.

The VAT exemption does not apply to inventories sold alone.

Transfer taxes

In principle, the buyer pays French registration tax. However, article 1705 of the French Tax Code provides for the joint and several liability of both the buyer and the seller for the payment of this tax.

The transfer of immovable property is subject to a transfer tax that ranges between 5 percent and 6 percent (plus notary fees), calculated on the sale price (or the fair market value of the related assets if higher). The rate can vary depending on the place where the immovable property is located.

In the transfer of a business, the word 'business' refers to the French notion of '*fonds de commerce*'. From a legal standpoint, a *fonds de commerce* is an aggregate of business assets, both tangible and intangible, used in a particular business. It consists mainly of a clientele attached to a particular group of business assets. It may also consist of a right to a lease or a specific collection of equipment, tools and merchandise.

Article 719 of the French Tax Code stipulates that the transfer of a business would trigger the payment of a transfer tax amounting to:

— 3 percent for the portion of the sale price (or fair market value, if higher) between EUR23,000 and EUR200,000

— 5 percent for the portion of the sale price (or fair market value, if higher) that exceeds EUR200,000.

The tax is assessed on:

— the intangible assets transferred, such as clientele, goodwill, leasehold rights to the business premises, patents, inventions, trademarks, current contracts (e.g. distribution agreements), licenses and administrative authorizations

— tangible fixed assets, such as furniture and equipment

— tools and supplies.

New merchandise (inventories) is usually not subject to French registration tax or VAT if certain conditions are met (French Tax Code, articles 723 and 257). When these conditions are not fulfilled, the new merchandise is subject to VAT.

Purchase of shares

Tax indemnities and warranties

In the case of negotiated acquisitions, it is usual for the buyer to request, and the seller to provide, indemnities and warranties as to any undisclosed tax liabilities of the company to be acquired. The extent of the indemnities and warranties is a matter for negotiation. Where an acquisition is made by way of a market raid or hostile takeover, it is not possible by virtue of the nature of the acquisition to seek warranties or indemnities.

Tax losses

French tax legislation does not include any rule restricting the validity of tax losses in the case of a change of ownership. However, specific restrictions have to be considered for tax losses crystallized in a tax group.

Tax losses generated by the target company cannot be offset against the profits of other companies that are members of the tax group, but tax losses may be offset against the company's own future profits (subject to conditions and limitations).

Where a French target company with trading losses is acquired, these losses may be used against its own future trading profits unless the company undergoes a 'real change of activity' or changes its tax regime. The concept of a 'real change of activity' has recently been clarified by French tax law. It now includes the addition, discontinuance or transfer of an activity that entails, respectively, an increase or a decrease of over 50 percent (relative to the previous FY) in either revenue or the average headcount and gross amount of fixed assets.

For FYs ending after 20 September 2011, the following limitations apply to the utilization of losses:

— carry back of prior-year losses is limited to EUR1 million; a credit is granted that can be used to pay CIT in the following 5 years and is refundable in the sixth year

— carry forward of losses to offset against profits of future year is limited to EUR1 million plus 50 percent of the taxable result exceeding that threshold.

Crystallization of tax charges

If the target belongs to a tax-consolidated group, de-consolidation costs could arise if the acquisition leads to dissolution of the tax group or at least the exit of the target from the tax group. Such costs would crystallize at the level of the head of the tax group. Indirect costs must also be considered in some cases, such as an increase in the number of employees profit sharing during the FYs following the deconsolidation (for the subsidiaries that generated losses within the tax group). Also, a potential indemnification of the exiting company could be considered in relation to the tax losses transferred to the group (a case-by-case analysis is required, in particular considering the tax-consolidation agreement in place).

Pre-sale dividend

A dividend distribution and a capital gain realized on a sale of shares may benefit from a full tax exemption when some conditions are met. Pre-sale dividend issues arise in France since, in the case of dividends distribution, the lump sum that remains taxable corresponds to 5 percent of the distributed dividends while it corresponds to 12 percent of the realized capital gain (provided the parent company held the shares for at least 2 years, among other conditions). As a result, it could be advantageous for a company to make a dividend distribution prior to a sale of shares.

Additionally, within a tax-consolidated group, dividend distributions are no longer fully exempt as of FYs starting on or after 1 January 2016, and a lump sum of 1 percent remains taxable. Under certain conditions, this regime also applies to dividends received from EU and EEA companies.

Otherwise, a sale of shares or a dividend distribution is subject to the standard CIT rate.

Pre-sale transfer of debt of the target entity

Where the seller has a receivable from the company the shares of which will be disposed of and the fair market value of the receivable is lower than its nominal value, the capitalization of the receivable before the sale or its sale to the buyer followed by its capitalization by the buyer (new shareholder) is not treated similarly for tax purposes. An in-depth analysis is required on a case-by-case basis.

Transfer taxes

The transfer of shares in a joint stock company, i.e. an SA (corporation), SAS (simplified joint stock company) or SCA (*société en commandite par actions*) is subject to transfer tax at the rate of 0.1 percent.

The transfer of shares in all other corporate companies, such as SARLs (limited liability companies) or partnerships (e.g. SNC — general partnership or SCS — limited partnership) is subject to transfer taxes at the rate of 3 percent for that part of the price exceeding EUR23,000. The tax base is reduced by EUR23,000 multiplied by the percentage that the shares to be disposed of represent of the capital of the company.

However, no transfer tax is due where the seller and buyer belong to the same economic or tax-consolidated group.

By exception, companies whose assets are more than 50 percent real estate (*société à prépondérance immobilière*) (the comparison is made on the basis of the respective fair market values) are subject to transfer tax at the rate of 5 percent (with no allowance and no cap), regardless of the legal status of the company (or the membership to the same group of companies). The intragroup exemption is not available where the 5 percent transfer tax applies.

Transfer tax is assessed on the sale price increased of liabilities taken over by the buyer or the fair market value if higher.

Tax clearances

It is not possible to obtain a clearance from the French tax authorities giving assurance that a potential target company has no tax arrears or is not involved in a tax dispute.

Choice of acquisition vehicle

The following vehicles may all be used to acquire the shares or assets of the target company:

— subsidiary

— branch of a foreign company

— treaty country intermediary company

— local holding company

— joint venture

— other special purpose vehicle (such as a partnership).

The choice of the structure can be critical for tax purposes, especially if it is intended to set up a tax-consolidated group.

Moreover, some specific constraints must be taken into account, such as thin capitalization rules (see later in the report) as well as the Charasse and Carrez amendment rules.

The Charasse amendment rule applies where a tax-consolidated group member purchases a company outside the tax-consolidated group from shareholders that directly or indirectly control both companies ('control' is defined by the French Commercial Code) and the target company becomes a member of the same tax-consolidated group. In this case, a portion of the group's financial expenses is not deductible for tax purposes for 9 years, even if no loan is used to purchase the target company. In case of acquisition from a third-party, followed by an internal reclassification of the shares of the French companies, it may be possible to fall outside the scope of the Charasse amendment, subject to strict conditions.

According to the Carrez amendment rule, the deduction of interest expenses relating to the acquisition of qualifying participations (*titres de participation*) requires substantiating that those participations are effectively managed by the company holding them or by a company established in France and belonging to the same economic group (subject to conditions). For FYs ending on or after 31 December 2017, companies established in the EU or a member state of the EEA that has concluded a treaty providing for administrative assistance are 'assimilated' to companies established in France. In other words, the French company can be managed by a company established in France, the EU or the EEA under certain conditions. In addition, when the subsidiary can be considered to be 'controlled' by another company within the meaning of the French Commercial Code, such control must be effectively exercised from France or the above territories. Otherwise, a portion of all the taxpayer's interest expenses is considered as non-tax-deductible and must be added back to its tax result. This add-back is made over a period of 8 years, starting in the year following that of the acquisition of the qualifying participation.

Local holding company

If profits are to be reinvested in the business or invested in other undertakings carried on by the buyer in France, the buyer should consider incorporating a local holding company to act as a dividend trap. The local holding company would receive the dividends from the ventures carried on in France or abroad by the group free of tax (i.e. exempt up to 95 percent, decreased to 99 percent in the case of tax consolidation as of 1 January 2016, subject to conditions). In addition, using a French holding company partly funded by debt and forming a tax group with the target could allow the interest paid by the parent company to be offset against the operating profits of the target (subject to anti-hybrid rules, thin capitalization restrictions, the Charasse and Carrez amendment rules and the general limitation on interest deductibility). The holding company could reinvest those dividends in other subsidiaries. Obviously, the French holding company must have sufficient substance in France.

Foreign parent company

The use of a foreign parent company to acquire the shares or assets of the target company has important tax consequences for dividend distributions and interest.

The French Tax Code stipulates that dividends distributed by French companies to non-residents, in principle, attract a WHT to be levied and paid to the tax authorities by the distributing company. The statutory rate of this WHT is, in principle, currently 30 percent where the dividends are distributed to legal entities (75 percent where the recipient is located in a so-called 'non-cooperative' country or territory). The rate is expected to be aligned with the domestic CIT rate as of 1 January 2020. The WHT rate may be reduced by one of France's tax treaties, where certain requirements are met.

According to article 119 *ter* of the French Tax Code, which incorporates the EU Parent Subsidiary Directive, dividends paid by a French company to its EU member state parent company (which must be the beneficial owner of the dividends) are exempt from WHT when the following conditions are met:

— The parent company and the distributing subsidiary take the form of one of the companies listed in the appendix to the 2011/96 EU Directive.

— Both companies are subject to corporate tax at the standard rate in the EU or EEA member state in which they are located.

— The parent company's effective place of management is in an EU or EEA member state.

— The parent company has held at least 10 percent of the subsidiary's share capital for at least 2 years (or has committed to hold the participation for at least 2 years).

— For FYs ending on or after 31 December 2015, parent companies established in another EU member state or EEA country can legally benefit from the EU WHT exemption if they hold 5 to 10 percent of the capital of the distributing company and have no opportunity to offset French WHT against the tax due in their country.

The WHT exemption regime is applicable to companies established in the EEA (i.e., Iceland, Norway and Liechtenstein) for FYs ending on or after 31 December

2015 (subject to the existence of a tax treaty providing for administrative assistance).

Moreover, the anti-abuse clause was amended to comply with EU directives for FYs starting on or after 1 January 2016. As a consequence, the WHT exemption does not apply when the distribution is made in the context of an arrangement or a series of arrangements, one of the main purposes of which is to obtain a tax advantage in contradiction with the object or purpose of the regime and that is not 'authentic', having regard to all relevant facts and circumstances (i.e., it is not set up for valid commercial purposes reflecting the economic reality).

Finally, the French Tax Code provides that interest paid by French individuals or companies to non-resident entities is, in principle, exempt from French WHT unless the interest is paid to a so-called 'non-cooperative' country or territory (WHT applies at the rate of 75 percent in this case).

Non-resident intermediate holding company

Most tax treaties signed by France contain provisions designed to prevent treaty shopping. The fact that an EU holding company is controlled by non-EU investors does not necessarily prevent the application of the EU Directive; this depends on each case and on compliance with the above anti-abuse clause.

Also, the French courts consider that a tax treaty may only apply when the recipient of the revenue meets a 'beneficial ownership' test, even if the applicable tax treaty does not specifically mention it.

Local branch

When profits will be regularly repatriated, it is sometimes desirable to form a branch or use an existing one to acquire the assets of the target company. The remittance of branch profits is subject to a 30 percent special branch profits tax. Tax treaties may provide for a lower rate or exemption from this tax. Moreover, no branch tax is levied within the EU when the company at stake is subject to corporate tax in the state where it has its effective place of management.

French CIT applies the same way to branches and subsidiaries and, except for the branch tax, no WHT is levied in France on branch profits of foreign companies.

A French branch of a foreign entity may be the head of a French tax group.

A number of legal and tax issues need to be considered when choosing between a branch and a subsidiary. The main tax issues concern CIT. Examples are as follows:

— Head office expenses reasonably attributable to subsidiary and a parent company are only deductible if carried out on an arm's length basis.

— Branch profits, whether or not remitted to head office, are subject to a 30 percent WHT or branch tax[1], depending on the relevant tax treaty, although an exemption may be obtained if there is no remittance.

— The profits of a subsidiary are subject to WHT only if they are distributed. Dividend distributions made abroad are subject to a 30 percent WHT, which is normally reduced by tax treaties.

— Moreover, there is a WHT exemption on the basis of the EU directive (see 'Foreign parent company'), except where the head office is not located in an EU or EEA member state.

— Branches generally are not covered by France's tax treaties and thus cannot usually benefit from them. Subsidiaries are French entities and thus qualify for reductions or exemptions from taxes.

— Branches are not presently entitled to claim a credit for foreign taxes paid, whereas subsidiaries, as residents, may claim a credit for foreign taxes (in particular, WHT).

Joint venture

Where an acquisition is to be made in conjunction with another party, the question arises as to the most appropriate vehicle for such a joint venture. Although a partnership can be used, in most cases, the parties prefer to conduct the joint venture via a limited liability company. A limited liability company offers the advantages of incorporation (legal existence separate from that of its members) and limited liability for its members. In a partnership, the partners have unlimited joint and several liability for the debts of the partnership.

Choice of acquisition funding

A buyer using a French acquisition vehicle to carry out an acquisition for cash needs to decide whether to fund the vehicle with debt or equity. The tax implications of the two approaches are discussed later in the report.

Debt

The principal advantage of debt is the potential tax-deductibility of interest paid to a related party or to a bank in the framework of a bank loan.

Deductibility of interest

Generally, interest paid by a company is tax-deductible. However, French tax rules include an exception concerning the deductibility of interest paid to shareholders. Such interest is tax-deductible only if the borrowing company's capital is fully paid-up (article 39.1.3 of the French Tax Code), and only up to the rate of the yearly average of average effective rates accorded to companies by credit institutions for variable rate loans having an initial duration

[1] The rate is expected to be aligned with the domestic CIT rate as of January 1, 2020

of over 2 years (article 39.1.3 of the French Tax Code). For FYs ending on December 31, 2017, the maximum deductible interest rate was 1.67 percent.

French thin capitalization rules apply to any loan or advance between affiliated companies and between sister companies.

Interest paid to a related party should not exceed the interest rate provided for by article 39.1.3 of the French Tax Code. Any excess interest is permanently non-tax-deductible and may be subject to WHT if paid abroad. However, a higher rate can be accepted for tax purposes (provided that the lender is a related entity, i.e. the lender controls the borrower, or the borrower controls the lender, or both of them are controlled by the same person) if it corresponds to a rate the French paying entity could have obtained from a third-party bank. In this case, the paying company must prove that the interest rate used is arm's length (e.g. by providing bank offers).

Then it must be determined whether the theoretically deductible interest can be effectively deducted in the FY of accrual. This would be the case if the paying company is not considered thinly capitalized, that is, where the borrower meets one of the following three ratios:

— the borrower's intragroup debt-to-net-equity ratio does not exceed 1.5:1 (debt-to-equity ratio)

— the amount of interest does not exceed 25 percent of the current pre-tax result plus intragroup interest and deductible depreciation (interest coverage limit)

— the amount of interest does not exceed the total interest amount received by the French borrower from affiliated entities (received intragroup interest limit).

Where the amount of acceptable interest simultaneously exceeds these three thresholds, the excess amount is not immediately deductible but it can be carried forward to future FYs. The deferred interest is deductible in the following FY (FY + 1) if the interest accrued during FY + 1 does not exceed the interest coverage limit of FY + 1. If it does, the deferred interest is deductible only up to the difference between the interest coverage limit of FY + 1 and the amount of FY + 1 interest. The part of the deferred interest not available for deduction in FY + 1 is rolled over, but the amount of the deferred interest is decreased by 5 percent per year as from the second year of carry forward.

These French thin capitalization rules also apply to all loans that, while borrowed from a third-party company, are guaranteed by an affiliated company, subject to certain exceptions (e.g. bonds issued under a public offer or pledge on borrowers' shares).

Affected guarantees include personal safety guarantees (e.g. personal securities, first demand guarantees and even letters of comfort in certain circumstances) and security interests (e.g. pledges of the debtor's securities, mortgages).

The interest limitation does not apply:

— where the borrower proves that the debt-to-net-equity ratio of the group equals or exceeds its own debt-to-net-equity ratio

— to certain financial transactions or structures (i.e. group cash pools, credit institutions and goods leased through finance leases) under certain conditions

— where the portion of interest that is not immediately deductible is less than EUR150,000.

In addition, specific rules apply to tax-consolidated groups: generally, a deferred interest is limited to the excess of the interest paid to related (but not tax-consolidated) entities over the 25 percent coverage limit computed at the level of the tax group.

The Carrez amendment rule disallows deductions of interest expenses relating to the acquisition of qualifying participations (*titres de participation*) that are not managed by the company holding them or by a company established in the EU or an EEA member state that has concluded with France a tax treaty providing for administrative assistance and belonging to the same economic group.

Additionally, a general restriction to the deductibility of interest ('25 percent haircut') was introduced for FYs starting on or after 1 January 2014. Only 75 percent of the net interest expenses are tax-deductible (unless such net interest expenses are lower than EUR3 million).

Finally, there is an anti-abuse mechanism for indebtedness involving related parties. Interest related to loans granted by related parties is only deductible where the lender's interest income is subject to income tax equal to at least 25 percent of the standard French income tax (if the lender is a foreign tax resident, the comparison is made with the theoretical income tax that would have been due in France if the lender had been a French tax resident).

Withholding tax on interest and methods to reduce or eliminate withholding tax

As of 1 March 2010, the general rule is that French-source interest is exempt from French WHT (unless it is characterized as a constructive dividend, in which case the WHT related to dividends may apply).

The sole exception to this exemption concerns the interest arising on financial advances paid into non-cooperative jurisdictions. According to French tax law, non-cooperative jurisdictions are countries and territories that:

— are not EU member states

— have not concluded treaties with at least 12 different member states or territories containing a mutual assistance clause allowing for the exchange of information

— have not entered into any such treaty with France.

The French tax authorities publish a list of non-cooperative jurisdictions annually. As of 1 January 2016, the non-cooperative countries or territories are Botswana, Brunei, Guatemala, Marshall Islands, Nauru, Niue and Panama.

The interest derived from financial advances granted by entities located in such jurisdictions is subject to a 75 percent French WHT, unless the debtor demonstrates that the underlying transactions do not intend or lead to the interest revenue being located in a non-cooperative jurisdiction.

Checklist for debt funding

The use of bank debt may avoid thin capitalization, the recently enacted anti-abuse mechanism (i.e. allowing interest deductibility only where there is sufficient taxation of the interest income at lender' level) and transfer pricing problems (regarding the evaluation of the arm's length interest rate).

Interest paid by a company in the framework of a bank loan is tax-deductible when some conditions are met. In particular:

— The loan must be granted in compliance with the borrower's own interest.

— Thin capitalization rules must be considered if the loan is secured by a related party.

— The Charasse and Carrez amendments (see above) must be considered.

— The interest expense must be considered in calculating the 25 percent haircut (see above).

Equity

If there is a risk of non-deductibility of interest, it may be better to use equity to fund the acquisition.

Under French corporate law, the share capital of a company may be increased to finance the acquisition. This capital increase may result from a cash contribution or from issuing new shares to the seller in consideration of a contribution.

From a French transfer tax standpoint, increasing share capital by way of a contribution under the *apport à titre pur et simple regime* (i.e. the sole consideration received in exchange should be new shares issued by the French company) only triggers the payment of a nominal fixed transfer tax of EUR375 (if the contributed company's share capital is less than EUR225,000) or EUR500 (if higher).

Tax treatment of reorganizations

Mergers

The following comments on the restructuring of companies focus on mergers. Specific issues arising from dissolutions, split-ups and spin-offs are dealt with separately.

Direct taxes

A merger involves the dissolution of the absorbed company generally followed by an increase in the capital of the absorbing company.

The absorbed company is taxed at the current rate of CIT on the profit and provisions of the FY. A 3.3 percent surtax applies on the amount of CIT that exceeds EUR763,000.

Long-term capital gains arising from the transfer of qualifying shareholdings (held for at least 2 years) are 88 percent exempt.

Short-term capital gains are taxed at the same rates as business profits.

The absorbing company generally acquires the assets transferred free of tax.

Preferential treatment is available in the case of mergers (Article 210 A of the French Tax Code), subject to an election. The principal advantages of this treatment are as follows:

— The absorbed company is not subject to CIT on net capital gains on fixed assets transferred in a merger.

— In general, from an accounting standpoint, the assets and liabilities transferred are booked in the accounts of the absorbing entity on the basis of their net book value. Exceptions exist in rare cases, e.g. where the merger is realized between unrelated parties (unless it is a reverse merger). In such a case, attention must be paid to the accounting / tax consequences of the merger in particular on the depreciable fixed assets.

— The absorbing company must include in its own balance sheet the provisions and depreciations made by the absorbed company.

— Capital gains on non-depreciable assets can be exempt from French CIT and are not taxed even if the fair market value of these assets is higher than their value in the absorbed company's accounts.

— If the absorbing company re-sells a non-depreciable asset, it must calculate the capital gain or loss on the basis of the tax value of the asset in the absorbed company's accounts (rollover).

— If the absorbing company sells the transferred assets, the relevant date for long-and short-term capital gains is the date of acquisition by the absorbed company.

In principle, the absorbed company's losses cannot be offset against the absorbing company's profits, except when a special ruling from the tax authorities is granted. This ruling can only be obtained when the merger is carried out under the preferential regime and where certain conditions regarding the transferred activities are met.

Registration tax

Under article 816 of the French Tax Code, the merger of two companies is subject to transfer taxes, paid by the absorbing company at a fixed amount (EUR375 if the absorbed company's share capital is lower than EUR225,000, and EUR500 if higher).

Retroactive effect

Mergers may be given retroactive effect from both accounting and tax standpoints. However, the merger's effective date cannot be earlier than the more recent of:

— the first day of the absorbing company's FY

— the first day of the absorbed company's FY.

This provision enables the results realized by the absorbed company during the months preceding the effective date of the merger to be offset against the profits and losses incurred by the absorbing company in the same period.

Note that no retroactivity is considered for business tax (CVAE) purposes.

Dissolution without liquidation

Direct tax

According to article 1844-5 of the French Civil Code, the dissolution without liquidation (*transmission universelle de patrimoine*) of a company owned by a sole shareholder is not followed by its liquidation. Instead, it entails the transfer of all the company's assets and liabilities to the sole shareholder. The dissolution without liquidation qualifies for the favorable tax regime under Article 210 A of the French Tax Code as described above for mergers.

Thus, the tax treatment of dissolution is the same as that for mergers.

Registration tax

The dissolution of the merged company is subject to a transfer tax of EUR375 or EUR500 (article 811 of the French Tax Code), depending on the share capital of the dissolved company. However, the transfer of real estate resulting from such a transaction can be subject to a registration tax of 0.715 percent (article 678 of the French Tax Code).

Retroactive effect

Dissolutions may have a retroactive effect only from a tax standpoint. Unlike mergers, retroactive effect is not allowed for dissolutions from an accounting standpoint.

Note that no retroactivity is considered for business tax (CVAE) purposes.

Spin-off

A spin-off (or partial business transfer) is a transaction whereby a company transfers part of its assets and liabilities to another company in exchange for shares. The portion of assets transferred must constitute a complete and autonomous branch of activity.

The concept of a complete and autonomous branch of business requires that the collection of assets and liabilities to be transferred are those of a division of a company that constitutes, from a technical standpoint, an independent activity capable of being carried on using the division's own resources under normal conditions in the economic sector concerned. In short, a complete and autonomous branch of activity is a collection of assets and liabilities of a company's division able to carry out an activity autonomously. As of 1 January 2018, a contribution of securities to reinforce a majority shareholding can qualify as a complete and autonomous branch of business.

Regarding direct taxes, under article 210 B of the French Tax Code, a partial transfer is eligible for the favorable tax treatment applicable to mergers if all the following conditions are met (in addition to the above conditions for mergers in general):

— The transfer relates to a complete and autonomous branch of activity.

— The transferring company commits itself to calculate capital gains on the sale of shares with reference to the value that the assets had in its own accounts from a tax standpoint.

Note that the remuneration of the contribution must be calculated on the basis of the respective fair market values, subject to a strict exception, which rarely applies.

If one of these conditions is not met, it remains possible to obtain a ruling from the French tax authorities. This ruling may be granted by right where:

— The contribution is based on economic reasons and is not motivated by tax avoidance reasons.

— The transferring company commits to hold the shares received in consideration of the contribution for at least 3 years.

— All guarantees are provided to the French tax authorities that they will subsequently be able to tax the capital gains on which the taxation has been deferred.

As of 1 January 2018, mergers, spin-offs and partial business transfers realized with foreign companies are no longer subject to a compulsory prior approval by the French tax authorities. The favorable tax regime for mergers automatically applies to these transactions, subject to filing requirements (documenting the reasons for and consequences of the transaction) and the allocation of the assets contributed to a French permanent establishment of the recipient of the contribution. Note that this obligation to allocate the shares to a French permanent establishment does not seem to apply to participations contributed in the context of spin-offs (subject to future comments of the French tax authorities).

Regarding registration tax, the transfer is subject to the favorable treatment provided for in article 817 of the French Tax Code, which limits the registration tax to a fixed amount of EUR375 or EUR500, depending on whether the level of share capital is lower than or equal to or higher than EUR225,000.

Split-up

The split-up of a company (*scission*) is a legal transaction whereby all the assets and liabilities of the company are transferred to two or more new companies. The old company ceases to exist and its shareholders receive the shares issued by the new companies. The favorable treatment available for mergers/spin-offs for direct tax can also be applied to the split-up to the extent that:

— The split-up company transfers at least one autonomous branch of activity to each company benefiting from the contribution.

— The shareholders who held at least 5 percent of the split-up company commit to keep the shares of the beneficiary companies or the new company for at least 3 years.

The favorable transfer tax treatment applicable to mergers also applies to a split-up.

However, the favorable tax treatment only applies to a split-up within the framework of a reorganization and not to a split-up resulting in equity sharing.

Deferred settlement

Deferred payments under earn-out clauses are subject to the same tax treatment as capital gains or losses realized on the sale.

Other considerations

Concerns of the seller

Capital gains are taxable at the standard French CIT rate subject to the restriction noted above. Transfer taxes are generally payable by the buyer.

The seller would mainly be concerned with the indemnities and/or warranties requested by the buyer (usually subject to negotiation).

For companies, capital gains on the sale of qualifying shareholdings held for at least 2 years are 88 percent exempt from tax. If the shares sold do not qualify as substantial shareholdings, the capital gain is taxable at the standard CIT rate.

For individuals, before 1 January 2018, capital gains were subject to personal income tax at the progressive rates (up to 45 percent) after application of an allowance of:

— 50 percent where the shares were held for 2 to 8 years

— 65 percent where they have been held for more than 8 years (higher allowances exist for shares of small and medium enterprises, subject to conditions).

Capital gains were also subject to social contribution at a rate of 15.5 percent (with no allowance).

As of 1 January 2018, a flat rate tax (*prélèvement forfaitaire unique*) is imposed on investment income, including capital gains from the sale of shares, parts and other income and assimilated gains. At the same time, most of the existing allowances are repealed. The overall rate for the flat rate tax is set at 30 percent in total, including income tax at 12.8 percent and social surtaxes (i.e. 'Contribution Sociale Généralisée', 'Contribution à la Réduction de la Dette Sociale', additional social withholdings), for an effective rate of 17.2 percent.

By exception, the taxpayer can choose, by an irrevocable and global option, to have investment income including capital gains subject to personal income tax at progressive rates (up to 45 percent).

A 12.8 percent WHT applies to capital gains on qualifying shareholdings (held in entities that are not qualified as real estate entities) derived by non-residents individuals. When the seller is a non-resident company, the WHT rate is aligned with the domestic CIT rate; non-resident companies could benefit from the holding period allowance, subject to conditions. In any case, a 75 percent WHT would apply where the seller is located in a non-cooperative country or territory.

Company law and accounting

Types of reorganization

— Merger (*fusion*) involves the absorption of one company by another company. The absorbing company may be a new company that takes over one or more existing companies, or it may be an existing company that takes over one or more existing companies.

— Split-up (*scission*) consists of the transfer of all of a company's assets to two or more existing or new companies. In principle, a split-up involves complete and independent branches of activity.

— Spin-off (*apport partiel*) occurs when a complete and independent branch of activity of one company is transferred to another company. The spin-off may be made to an existing company or a new company (it may also involve the contribution of isolated asset(s) under French law but, in that case, the transaction would not benefit from the favorable tax regime).

— Dissolution without liquidation (*transmission universelle de patrimoine*) occurs when all shares of a company are held by a single shareholder; it may be decided to dissolve this company, leading to a transfer of all its assets and liabilities to the single shareholder.

— Exchange of shares (*fusion à l'anglaise*) occurs when a contribution of shares is deemed to be a complete branch of activity benefiting from the favorable tax treatment for CIT purposes in three cases:

  — where the contribution applies to more than 50 percent of the capital of the contributing company

— where the contribution confers on the beneficiary company a direct holding percentage of the voting rights, when no other partners hold more

— where the beneficiary company already holds more than 30 percent and the contributions give it the majority of the voting rights.

Investment in France

France's regulations on foreign investment are relatively relaxed. In principle, investment in France does not require prior approval from the exchange control authorities. Nevertheless, foreign investment in certain economic sectors must be pre-approved by the Ministry of Finance, based on the fulfillment of certain conditions. The approval is deemed to be granted if, within 2 months of filing a prior authorization, the Ministry of Finance has not opposed the investment.

On 15 May 2014, a decree was enacted to update the list of activities requiring prior authorization, taking into account those activities currently deemed essential to guarantee France's interest in public order, public security and national defense.

Before the 2014 decree, 11 types of activity connected with public health, public security and public authority fell within the scope of the prior authorization regime.

For non-EU investors, the 2014 decree significantly extends the scope of the regime to other activities, in particular relating to materials, products or services ensuring the protection of public health or the integrity, security and continuity of:

— the supply of electricity, gas, hydrocarbons or other energy resources

— the supply of water

— the operation of transport networks and services

— operation of electronic communication networks and services.

The applicability of this regime also depends on conditions relating to the nature of the investment and the nationality of the foreign investors (inside or outside the EU), which have not been modified.

The following investments from a third country are subject to prior authorization:

— acquisition of control of a French company

— direct or indirect acquisition of all or part of a branch of activity of a French company

— the crossing of the 33 percent threshold of direct or indirect holding of the share capital or of the voting rights of a French company (applicable to non-EU investors only).

Prior authorization is deemed to have been obtained for:

— Investments between companies that are members of the same group, which means that the same shareholder holds more than 50 percent of the share capital or of the voting rights of the entity, unless their aim is to transfer abroad all or part of a branch of activity belonging to a type of activity mentioned above (sensitive activity).

— Investments made by an investor that holds more than 33 percent of the direct or indirect shareholding or voting rights and that has already been authorized to acquire control of the entity.

Non-compliance with this prior authorization regime constitutes a criminal offence, which may be punishable by a maximum 5-year prison sentence and a maximum fine equal to 2 times the amount of the investment.

Moreover, if the prior authorization has not been obtained, the agreement (and/or commitment directly or indirectly materializing the foreign investment) is deemed null and void.

Lastly, some categories of investments must be reported to the Banque de France for statistical purposes, notably:

— acquisition of at least 10 percent or crossing of the 10 percent threshold of share capital or voting rights of French or foreign company by respectively non-residents or residents, over EUR15 million

— any transaction between related companies (i.e. loans, deposits, etc.) over EUR15 million

— real estate investments

— payments made in France between a resident and a non-resident over EUR12,500

— for residents, outstanding amounts of their assets and receivables or debts abroad exceeding EUR30 million

— acquisition or sale of a foreign company by a resident over EUR15 million

— acquisition or sale of real estate in France by a non-resident and abroad by a resident over EUR15 million

— liquidations of foreign investments in France.

These rules are applicable to mergers and takeovers.

Choice of entity for investing in France

Commercial companies are divided into joint stock companies (*sociétés de capitaux*) and partnerships (*sociétés de personnes*).

The most frequently used company forms in France are the SA (corporation), the SAS (simplified joint-stock company) and the SARL (limited liability company).

Corporation, *Société Anonyme* (SA)

— Earnings are taxed once at the corporate level.

— Distributions of after-tax earnings are also taxed at the shareholder level. France reduces the financial effect of taxing corporate profits twice (at the entity and recipient levels). There is no deduction for dividends paid to a company. However, if the parent company owns at least 5 percent of the French subsidiary's share capital and keeps the shares for at least 2 years, the parent company is eligible for the 95 percent dividend exemption provided for by article 145 of the French Tax Code. The 5 percent share is taxed at the current tax rate. However, within a tax-consolidated group, dividends eligible for the participation exemption regime on dividends are subject to 1 percent taxation as of the first year of tax consolidation (for FYs ending on or before 31 December 2015, these dividends were 100 percent tax-exempt as of the second year of tax consolidation).

— Minimum share capital for an SA is EUR37,000.

— Shareholders have limited liability for the company's debts.

— There is no maximum number of shareholders (minimum seven for listed-companies and two for non-listed companies).

Limited liability company, *Société à Responsabilité Limitée* (SARL)

— Minimum share capital is EUR1.

— Minimum number of shareholders is one.

— Maximum number of shareholders is 100.

— The shareholders must give their prior majority approval to the transfer of SARL shares to third parties.

— Shareholders may participate in the management of the company.

— Taxed according to the same rules as an SA (except for family-owned SARLs, which may elect to be taxed as look-through entities).

Simplified joint-stock company, *Société par Actions Simplifiée* (SAS)

— Minimum number of shareholders is one.

— Both companies and individuals may be shareholders.

— Minimum share capital is EUR1 (introduced in *loi de Modernisation de l'économie-LME*, dated 4 August 2008).

— Taxed in the same way as an SA.

— Shareholders have limited liability for the company's debts.

— Restriction regarding public offering.

***General partnership, Société en Nom Collectif* (SNC)**

— No minimum or maximum capital requirements.

— Minimum of two partners.

— All the partners are jointly and severally liable for the partnership's liabilities.

— Not taxed at the entity level (unless an election for CIT is made).

— Partners are taxed on their share of earnings, whether or not distributed.

Limited partnership, *Société en Commandite Simple* (SCS)

— No minimum or maximum capital requirements.

— Minimum number of shareholders is two and at least one general partner (commandité) and one limited liability partner (*commanditaire*).

— Two categories of partners: general partners (*commandités*) and limited liability partners (*commanditaires*).

— General partners are jointly and severally liable for the company's debts.

— Liability of the limited liability partners is limited to the amount of their contribution to the SCS's capital subject to their absence of interference into the SCS's social management.

— General partners are subject to income tax on their share of the SCS's income, whether or not distributed.

— The limited liability partners' share of SCS income is subject to corporate tax at the SCS level. Dividend distributions to limited liability partners are taxed at their level under normal tax rules.

Limited stock partnership, *Société en Commandite par Actions* (SCA)

— Minimum share capital for SCA is EUR37,000.

— Minimum number of shareholders is one general partner (*commandité*) and three limited liability partners (*commanditaires*).

— General partners (*commandités*) are jointly and severally liable for the SCA's debts.

— Limited liability partners (*commanditaires*) are considered as shareholders and their liability for the SCA's debts is limited to the amount of their capital contribution.

— Taxed as an SA.

Group relief/consolidation

There is a special tax regime for groups of companies. A French parent company and its 95 percent-owned subsidiaries

may elect to be treated as a group so that CIT is imposed on the aggregate of the profits and losses of the group members.

The group may be composed of a parent company holding directly 95 percent or more of all its subsidiaries. A group may also exist if the 95 percent shareholding is held through other subsidiaries. Such subsidiaries can be located in France or an EU country (although in the latter case, the foreign intermediary subsidiary is excluded from the tax-consolidated group). The Corrective Finance Act for 2014 extended the scope of the tax consolidation mechanism to 'horizontal' tax-consolidated groups (i.e., between French-resident sister or cousin companies with their parent company established in another EU or EEA member state). Thus, one of the French sister or cousin companies is entitled to become the head of a French tax group subject to specific conditions.

To qualify for group treatment, all the companies must be subject to French CIT.

An election for this special regime is made for a period of 5 years. A new company may be included in the group. If a company leaves the group, adjustments must be made, which can be expensive for the parent company.

The group profit is taxed at the standard rate of CIT. The group profit or loss is the sum of all the members' profits and losses.

For FYs starting in 2016 and later years, the rule providing for neutralization of the 5 percent taxable share for dividends paid between entities of a French tax consolidated group is repealed. However, the taxable share is reduced to 1 percent for dividends that are received by a company (that is a member of a French tax group) from another company of the tax group or from a company established in an EU or EEA member state if this company, had it been French, would have met the conditions of being a member of the tax group. The 1 percent taxation applies from the first year of membership and to each level of shareholdings.

The advantages of group treatment are as follows:

— netting of the profits and losses of the companies of the group

— double taxation is avoided, so dividend distributions made within the group are exempt from corporate tax (but only up to 99 percent as of 1 January 2016, as explained above)

— tax-neutrality for transfers of assets and for transactions within the group (but clawed back if the group terminates or one company leaves the group).

The main drawbacks of the tax group regime are as follows:

— potential increase in the CIT rate (depending on the group's overall turnover)

— potential increase in the company value added contribution rate (depending on the group's overall turnover)

— potential limitation on the deduction of interest expenses (application of the Charasse amendment rule and appreciation of the EUR3 million threshold at the group level for application of the general limitation of the deductibility of interest expenses).

Transfer pricing

Where the companies involved in a cross-border reorganization have commercial relationships before the transaction, it may be necessary to review, modify or amend the transfer pricing agreement in force in order to avoid any potential transfer pricing reassessment.

Companies with turnover or gross assets of over EUR400 million (or companies held directly or indirectly by such an entity by more than 50 percent as well as companies holding directly or indirectly more than 50 percent of such an entity) are required to maintain at the disposal of the tax administration documentation justifying the transfer pricing policy with affiliated companies.

Under the Finance Act for 2018, this documentation must include other information not requested before and more precise information on certain topics, including:

— the supply chain for the main goods and services as well as a functional analysis of the role of the various entities of the group

— intangible assets and intragroup agreements regarding these assets

— information about the substantial financing transactions of the group.

For tax audits launched as of 1 January 2015, failure to provide the documentation to the French tax authorities (after formal notice) entails a fine of up to the higher of:

— 0.5 percent of the amount of the transaction for which complete documentation has not been provided, or

— 5 percent of the transfer pricing reassessment (in base).

The penalty cannot be less than EUR10,000.

For tax-consolidated groups, the parent company is required to file this declaration for both itself and each tax group member. The documentation must be filed in electronic format for each FY.

As of 11 December 2016, companies with turnover or gross assets on the balance sheet of over EUR50 million (or companies held directly or indirectly by such an entity by more than 50 percent as well as companies holding directly or indirectly more than 50 percent of such an entity) must file

an abridged version of their transfer pricing documentation (within 6 months of the date of the tax return filing). This abridged documentation must contain:

- general information regarding the group, such as:
  - a general description of the activities performed by the group, including any changes that occurred during the FY
  - a list of the main intangibles in relation to the French entity (e.g. patents, trademarks)
  - a general presentation of the group's transfer pricing policy and any changes that have occurred during the concerned fiscal year.
- Specific information about the entity, such as:
  - a description of the activities of the entity, including any changes that occurred during the FY
  - a summary of any transactions with other related entities where the aggregate amount per transaction type exceeds EUR100,000
  - a description of the method(s) used to determine transfer prices based on the arm's length principle; any change of method during the previous fiscal year must be indicated.

Finance Act for 2016 introduced a country-by-country (CbyC) reporting obligation (article 223 *quinquies* C of the French Tax Code) in accordance with Action 13 of the Organisation for Economic Cooperation and Development's (OECD) Action Plan on Base Erosion and Profit Shifting (BEPS). These reports are subject to automatic exchange between national tax authorities, and they are designed to reinforce the transfer pricing documentation obligations of multinational groups.

Two types of companies are required to prepare CbyC reports:

- companies that create and draw up consolidated accounts; belong to a group with a consolidated turnover in excess of EUR750 million; and have foreign branches or hold or control, directly or indirectly, foreign entities (except companies held by parent companies that are required to file a CbyC report in their state of incorporation)
- companies held by entities established in countries that do not participate in the automatic exchange of CbyC reports where:
  - the company is held, directly or indirectly, by a legal entity established in a state that does not participate in the automatic exchange and would be required to file the CbyC report if it were established in France, and
  - the company is designated to file the report by the group to which they belong or have not demonstrated that another entity of the group established in a country that participates in the automatic exchange has been designated to file the report.

The CbyC report must include a breakdown, by country, of the group's earnings and aggregate economic accounting and information on the location and activities of the different members and entities of the group. The report must be filed in electronic format for each FY. Failure to file the report would attract a penalty of up to EUR100,000.

The CbyC reporting requirements have applied for FYs starting on or after 1 January 2016. Accordingly, the first reports were filed by the end of 2017 and automatically exchanged between participating countries in 2018.

Foreign investments of a local target company

Profits made by controlled foreign companies (CFC) established in low-tax countries and whose parent companies are subject to French CIT are taxed at the French parent company's level according to Article 209 B of the French tax code. This treatment applies where the French company directly or indirectly holds more than 50 percent of the subsidiary's capital (5 percent if more than 50 percent of the CFC is held either by companies located in France or by companies that control or are controlled by such companies located in France).

For undertakings controlled by French companies and located in low-tax jurisdictions, the burden of proof is shifted to the taxpayer.

This measure does not apply if the French parent company can prove that the main effect of the CFC's transactions is other than that of locating profits in a low-tax country (which is generally the case where the subsidiary is engaged in an actual industrial or commercial business in the jurisdiction where its establishment or head office is located).

Further, article 209 B is not applicable to companies established in the EU unless the structure constitutes an artificial scheme that aims to avoid the application of French legislation.

Comparison of asset and share purchases

Advantages of asset purchases

- The purchase price (or a portion of it) can be depreciated or amortized for tax purposes (but not to the extent that it includes goodwill).
- A step-up in the cost base of individual assets for capital gains tax purposes is obtained.
- No previous liabilities of the company are inherited.
- It is possible to acquire only part of a business.
- There is more flexibility in funding options.

Disadvantages of asset purchases

— Possible need to renegotiate supply, employment and technology agreements, and change stationery.

— A higher capital outlay is usually involved (unless debts of the business are also assumed).

— May be unattractive to the seller, thereby increasing the price. In most cases, capital gains derived from the sales of assets are subject to the standard CIT rate whereas capital gains on shares generally benefit from an 88 percent exemption.

— Higher transfer duties (a transfer of goodwill is subject to higher registration tax than a sale of shares of an SA, SAS or SARL).

— Accounting profits may be affected by the creation of acquisition goodwill (at a consolidated level).

— The benefit of any losses incurred by the target company remains with the seller.

Advantages of share purchases

— Likely more attractive to the seller, so the price is likely lower.

— May benefit from tax losses of target company (the target company retains its tax losses).

— May gain benefit of existing supply or technology contracts.

— Transfer taxes are generally lower.

Disadvantages of share purchases

— Liable for any claims or previous liabilities of the entity.

— No deduction for the purchase price (but interest payable on acquisition financing may be deductible for the purchasing company).

— Less flexibility in funding options.

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Germany

Introduction

Germany has not seen major changes to its tax rules since the 2008 tax reform. Since then, the reform's new earnings-stripping rules and further restrictions on the use of tax loss carry forwards have been established without significant changes. The Organisation for Economic Co-operation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) initiative is not expected to lead to significant changes in German tax law, as many of the OECD's proposals (general anti-avoidance rules (GAAR)), anti-hybrid rules, controlled foreign company (CFC) rules, earnings-stripping rules) have been in place in Germany for many years.

Since the Bundestag elections in September 2017, Germany has been in the unusual situation of being without a formal government for such a long term. Coalition talks to form a three-party coalition between the Conservatives, Liberal Democrats and the Green Party have failed. The Conservatives will form a big coalition with Social Democrats, as was the case for the past 4 years. As a result, the prospect of major tax reforms, such as the abolishment of solidarity surcharge, seem to have vanished.

The formation of a government is ongoing, and, at the time of writing, results were expected to be announced during March 2018.

The following outline of German commercial and tax law is designed to inform foreign investors about their general tax options on the acquisition of a business in Germany. Unless otherwise stated, the commentary ignores Germany's solidarity surcharge of 5.5 percent on corporate and individual income tax.

Recent developments

Suspension of turnaround exemption

On 26 January 2011, the European Union (EU) Commission ruled that the exemption from the forfeiture of tax losses in a detrimental transfer of shares in turnaround situations constitutes illegal state aid and infringes EU freedoms providing for the European common market. The German government appealed this ruling before the General Court of the EU. The proceedings of the German government were dismissed as inadmissible on 18 December 2012 (EGC-Ruling T-205/11) as the period for filing an action had already expired. Numerous taxpayers have brought individual actions before the General Court. These cases are still pending.

In view of a potential decision of the EU Commission against the German government and resultant need to collect the granted tax benefits from taxpayers that claimed the turnaround exemption, the German tax authorities suspended application of this clause and stayed all appeals against assessments not applying the turnaround exemption as of April 2010, subject to the final decision of the Court of Justice of the EU (CJEU).

Tax loss deduction

On 28 November 2017, the Federal Ministry of Finance (BMF) promulgated its final guidance on the restriction of loss deduction for corporations as well as identical directives of the tax authorities of the Federal States on the application of section 8c CIT to trade tax losses. In particular, the guidance deals with the provisions for mid-year changes in ownership, group exemptions and hidden reserves exemptions that were introduced in 2009 and partly amended in 2010 and 2015.

In its decision of 29 March 2017, the Federal Constitutional Court ruled that the provisions on detrimental changes in ownership regarding shareholdings of up to 50 percent (section 8c par. 1 sent. 1 CIT) is unconstitutional to 31 December 2015. The legislator has until 31 December 2018 to introduce revised provisions that would apply retroactively for the period from 1 January 2008 to 31 December 2015 and remedy the identified infringement of the constitution. If not, the provision would be (retroactively) void for this period. Meanwhile, the Lower Tax Court of Hamburg has also referred the full forfeiture of losses in cases of detrimental changes in ownership regarding shareholdings of more than 50 percent (section 8c par. 1 sent. 2 CIT) to the Federal Constitutional Court for review.

Currently, no draft bill amending the provisions has been presented.

Further development of the corporate tax loss utilization

The Law of the Further Development of the Corporate Tax Loss Utilization, promulgated on 23 December 2016,

introduces section 8d CIT as an exception to the loss forfeiture required by the change of control rules (section 8c CIT). As a result, tax losses and interest carryforwards are retained on application, even where a detrimental change in ownership within the meaning of section 8c CIT has occurred, provided that the corporation has maintained the same business operations since its formation or for at least 3 years. Additionally, in this period of time until the end of the tax assessment period of the detrimental change in ownership, certain events must not occur. For example, during this period, the corporation must not:

— discontinue, suspend or change its business operations

— participate in a business partnership

— become a controlling entity in a tax group

— transfer business assets to the corporation for less than fair market value.

In the event of a discontinuation, suspension or change in the business operations, the continuation-linked loss carryforward are forfeited unless the hidden reserves clause applies. The same applies true where the corporation participates in a business partnership, becomes a controlling entity or business assets are transferred to the corporation under fair market value. However, only hidden reserves that exist at the end of the tax assessment period preceding the tax assessment period of the detrimental incident are captured.

The revisions are generally applicable to detrimental changes in ownership occurring after 31 December 2015.

Restructuring gains

The German legislator has implemented a law-regulated exemption for restructuring gains. However, the provisions reinstating the tax exemption for restructuring gains will only enter into force on the date when the EU Commission grants its approval under state aid law.

Restructuring gains typically arise where a creditor of a distressed company waives their debt claims for restructuring purposes. Until 1997, a legal provision allowed a tax exemption of restructuring gains. That provision was suspended, and since then, restructuring gains have been generally subject to taxation.

Reform of investment taxation

The Law on the Reform of Investment Taxation was promulgated in the Federal Law Gazette on 26 July 2016. The law fundamentally changes the tax treatment of investment funds, moving from a transparent system, with tax only levied on the investors, to a non-transparent system, with taxation at the fund level. The new provisions apply generally as of 1 January 2018. A provision on taxation of capital gains on portfolio investments contained in earlier drafts is no longer included. Thus, the currently applicable portfolio exemption for corporate tax (effectively 95 percent) remains in effect.

Deduction of special business expenses: transactions with foreign nexus

The law implementing the EU administrative assistance directive and further measures against BEPS includes a new regulation to prevent double deduction of special business expenses (§4i IT). The rule denies deductions of expenses as special business expenses insofar as they also reduce the tax assessment base in another state. The explanation of the law mentions an exemplary case where the participation of a foreign shareholder in a domestic partnership is financed by debt (special business expenses in Germany and refinancing expenses abroad).

The deduction restriction does not apply if the income from which the expenses are deducted is doubly recorded, for example, in the absence of a double tax treaty or in the context of a tax credit. A double consideration of expenses and income also exists in any case, pursuant to the reasoning of the law, where expenses and income accrued in different states are considered at different times.

The revision took effect as of tax assessment period 2017.

Anti-patent box law

The law to counter harmful tax practices connected to the licensing of rights was promulgated in the Federal Law Gazette on 4 July 2017. The law refers to Action 5 of the OECD BEPS project.

The new law restricts the tax-deductibility of royalty expenses and other expenses for the licensing of rights to related persons that are not taxed or only taxed at a low rate (below 25 percent) for the recipient by reason of a preferential regime that is considered as harmful. The revision covers expenditures for the licensing of use or the right to use rights, in particular copyrights and industrial property rights, commercial, technical, scientific and similar experiences, knowledge and skills. The law only applies to payments between related persons within the meaning Foreign Transactions Tax Law (i.e. in particular, in cases with participating interests of at least 25 percent) and is in effect for expenses accruing after 31 December 2017.

Real estate transfer tax

The German Federal Tax Court (BFH) has decided that an interest held in a partnership that holds shares in a real-estate-owning company is assessed based on the share in the capital of the partnership for real estate transfer tax (RETT) purposes [section 1 par. 3 RETT Law]. The share in the jointly held assets as defined under property law is not relevant.

This new decision marks a change in the case law of the BFH. According to the BFH, the share in a partnership now corresponds to the share in the partnership's capital, as is the case with corporations, and it is the percentage of shareholding that is relevant. Accordingly, after the acquisition, where at least 95 percent of the partnership's

share capital is attributable to the buyer, the requirement of an indirect unification of shares is met. This BFH decision may affect acquisition transactions effected until 6 June 2013. The introduction of the shareholding from an economic perspective as basis for RETT , which applies as of 7 June 2013, means that acquisition transactions with so-called 'RETT blockers' are also subject to taxation.

On 30 May 2017, the German Federal Tax Court referred a case to the CJEU requesting a preliminary ruling on whether the RETT relief granted under section 6a RETT Law for restructurings of corporate groups is regarded as illegal state aid under EU law. The decision of the CJEU is still pending.

Further, the German legislator has extended the period for required disclosures of foreign tax debtors to 1 month (from 2 weeks).

Assumptions of obligations, collateral Promises and assumptions of duty to perform

In 2014, new rules (section 4f and section 5 par. 7 IT) were introduced on the tax accounting treatment of transfers of obligations that are subject to balance sheet recognition prohibitions, restrictions or reservations regarding their valuation. These rules respond to case law of the German Federal Tax Court that conflicted with the opinion of the tax authorities. A number of questions and uncertainties have arisen since the rules were introduced. Some of these questions were addressed in the final BMF guidance issued on 30 November 2017, which is applicable to all open cases.

Asset purchase or share purchase

The form of an acquisition is often motivated by tax but also driven by other commercial and legal factors. The buyer's main preference, from a tax perspective, is to get a step-up in the acquired assets along with a corresponding depreciation base to reduce the future effective tax rate, which is achievable in assets deals or other taxable transactions, e.g. under German reorganization tax law. The seller's primary interest is to minimize capital gains tax or, ideally, to obtain a tax exemption. Share deals are generally more tax-efficient for all types of owners, whether corporates or individuals.

The transfer of ownership interests is legally simpler than the transfer of numerous scattered assets. It is easier to specify the interests or shares being disposed of than to identify individual assets. Contracts and licenses held by the purchased entity remain effective and may not need to be assumed (requiring the other parties' consent) or renegotiated. By contrast, assets deals allow an individual determination of the assets and liabilities transferred and therefore can provide more flexibility in carving out risk areas, etc. More complex transactions under the reorganization tax law allow for the combination of the legal benefits of a universal succession into a business' assets with a step-up in assets. This can especially be favorable in regulated industries if licenses need to be transferred.

Purchase of assets

In an asset purchase, the purchased assets are accorded a new cost base for the buyer, and the selling entity realizes a gain/loss amounting to the excess/shortfall of the purchase price over the book value of the assets. A deferral of capital gains may apply to certain fixed assets (replacement assets) in the case of reinvestments in either German or EU-based permanent establishments (PE). Generally, the allocation of any step-up/step-down is performed on an asset-by-asset basis. Goodwill generally is calculated as the difference between the purchase price and the sum of the stepped-up market values of the other assets and is capitalized at this value. An asset deal provides the buyer with the opportunity to buy only those assets actually desired and leave unwanted assets (e.g. environmentally contaminated real estate) and, in many cases, unwanted liabilities behind.

However, under German law, some liabilities cannot be avoided and pass to the buyer in an asset deal except under certain circumstances. For example, liabilities with respect to existing employment contracts (German Civil Code [*Bürgerliches Gesetzbuch* — BGB], section 613a) and several tax liabilities (*General Tax Act [Abgabenordnung* — AO], section 75) cannot be disclaimed. Although certain liabilities are taken over where the acquired commercial business is continued under the same name (German Commercial Code [*Handelsgesetzbuch* — HGB], section 25), such liabilities could be disclaimed under certain conditions.

From a buyer's tax perspective, the acquisition of a partnership interest is treated as a pro rata acquisition of the partnership's assets. Consequently, the buyer can step-up the basis in their pro rata share of partnership assets acquired to equal the full purchase price.

Purchase price

Where assets are purchased, the buyer should attempt to persuade the seller to agree to a detailed allocation of the purchase price to the assets. Such an allocation is not binding for tax purposes but provides a useful starting point. Non-competition agreements in connection with asset purchases are generally viewed as part of goodwill and do not constitute independent assets, unless a separate price is determined and allocated in the purchase agreement. The value added tax (VAT) implications of such separate agreements need to be taken into account.

Goodwill

The acquired tangible and intangible assets, including goodwill, are to be capitalized at their fair market values. For tax purposes, goodwill is amortized over a 15-year period, independent of the International Financial Reporting Standards (IFRS) or statutory accounting treatment. Consequently, deferred tax implications apply.

Depreciation

All other assets are depreciable over their useful lives. The tax authorities have published depreciation tables listing the relevant periods for almost every type of asset.

Contingent losses

The acquisition of liabilities that are not recognized in full in the tax balance sheet of the seller due to certain restrictions for tax accounting purposes results in a post-acquisition profit of the buyer in the business year of the acquisition as the buyer must apply the original accounting restrictions. The resulting profit may be spread over a period of 15 years, which may avoid taxation of the post-acquisition profit to some extent where the contingent tax loss is correspondingly realized in the same periods.

Tax attributes

Tax losses, interest and earnings before interest, taxes, depreciation and amortization (EBITDA) carried forward and other attributes are not transferred in an asset deal. They remain with the seller or are eliminated.

Value added tax

Asset purchases of a business or division (branch of activity) are generally not subject to German VAT law [USTG], section 1 par. 1a). Purchases of shares in a corporation or interests in a partnership are tax-exempt under USTG, section 4 par. 8 (f).

Transfer taxes

There is no stamp duty in Germany. However, the acquisition of property in an asset purchase is subject to RETT on the purchase price allocated to the property. The RETT rate ranges from 3.5 to 6.5 percent (depending on the German state in which the real estate is located). If an asset deal triggers RETT, the buyer and seller are generally liable. Typically, an asset purchase agreement allocates the RETT as a transaction cost to the buyer.

RETT is also triggered when at least 95 percent of the shares in a company or partnership owning real estate located in Germany are transferred, directly or indirectly. This also applies where less than 95 percent is transferred but, after the transfer, at least 95 percent of the entity is directly or indirectly owned by one taxpayer or a consolidated tax group. Different methods for calculating the 95 percent threshold apply for partnerships and corporations as of 2016. Further, a transaction triggers RETT where a person or company acquires an economic participation of at least 95 percent in a real estate-owning company. Such participation equals the sum of direct and indirect participations in the capital or assets of the company. In the case of indirect participations, the participations in the capital or assets must be multiplied on each participation level.

For partnerships, any direct or indirect share transfers within a 5-year period are added together for this 95 percent test. Previously, where RETT was triggered by the acquisition of shares in a company or partnership, the RETT was based on a special valuation of the real estate for tax purposes, which amounted to roughly 70 to 80 percent of the fair market value. This valuation method was overruled as unconstitutional in 2015. The valuation methodology of German Inheritance Tax Law applies retroactively as of 2009, leading to transfer values closer to fair market value. The buyer or direct or indirect owner of at least 95 percent in a real estate-owning corporation is liable for RETT.

There is an exemption of RETT for certain reorganizations within a group, including mergers, de-mergers (split-up, spin-off, carve-out) and certain other transfers of property. Similar reorganizations under the law of another EU or European Economic Area (EEA) member state are also privileged. According to the recently amended group exemption clause, contributions and other transactions on the basis of the articles of association also may be exempt from RETT. However, according to guidance from the tax authorities, the group exemption applies only to the transfer of real estate where the transaction allows for universal succession of the receiving entity in the position of the transferring entity.

Further, the group exemption only applies where a company and a controlled company are involved in the reorganization. A company is deemed controlled where the controlling company holds (directly or indirectly) an interest of at least 95 percent within a period of 5 years before and 5 years after the reorganization.

A CJEU decision is pending on whether this exemption is an illegal state aid.

Purchase of shares

A share deal does not offer the buyer a step-up of the assets (capitalization of assets at fair market value) of the purchased company to increase the depreciation base. The scope for achieving such a step-up by post-acquisition restructuring is limited. VAT and RETT implications are discussed earlier in this report.

Legal form of businesses

When buying a business, it is necessary to understand the legal form in which it is conducted. Most business activity in Germany is carried out through one of the following:

— sole proprietorship (*Einzelunternehmen*)

— general partnership (*offene Handelsgesellschaft* — oHG)

— limited partnership (*Kommanditgesellschaft* — KG)

— limited partnership with corporate general partner (GmbH and Co. KG)

— limited liability company (*Gesellschaft mit beschränkter Haftung* — GmbH)

— entrepreneurial company with limited liability (*Unternehmergesellschaft (haftungsbeschränkt)* — UG)

— stock corporation (*Aktiengesellschaft* — AG).

The federal German law governs these enterprises. A corporation (AG, GmbH, UG) is subject to corporate income tax (since 2008, 15 percent), solidarity surcharge (5.5 percent of the corporate tax), trade tax (approximately 14 percent), and VAT (19 percent standard rate). A partnership (oHG, KG, GmbH and Co. KG) is transparent for corporate income tax purposes (i.e. partnership income is attributed to and taxed in the hands of the partners) but not for trade tax purposes. An election to treat a partnership as a corporation is not possible for German tax purposes.

Of these legal forms, the GmbH and Co. KG, GmbH, UG and AG allow a limitation of the owners' liability to the agreed capital contribution. In the case of the GmbH and Co. KG, this applies, strictly speaking, only to the limited partners. The general partner, the GmbH, does not need to make any capital contribution or be entitled to any share of profits. The management of the GmbH and Co. KG usually rests with its general partner, the GmbH, but this is not mandatory.

Limited liability company: Gesellschaft mit beschränkter Haftung (GmbH)

The GmbH is the most common form of business association. It is a corporate entity with its own legal identity, one or more shareholders and share capital of at least EUR25,000. Shares in GmbHs are not certified.

The purchase and transfer of shares in an existing GmbH requires an agreement that must be recorded in the presence of a qualified German notary. Except for some cases in which Swiss notaries are considered as qualified, a transfer of GmbH shares before a foreign notary is generally not possible.

The management of a GmbH rests with one or more managing directors appointed by the shareholders. The managing directors are subject to close supervision and control by the shareholders and are generally obliged to respect instructions given to them at the shareholders' meeting. Where a GmbH has at least 500 employees, a supervisory board must be established according to provisions applicable to AGs. The shareholders control the distribution of net earnings.

Entrepreneurial company with limited liability: *Unternehmergesellschaft (haftungsbeschränkt)* (UG)

The legal form of the UG was established by the German Act to Modernize the Law Governing Limited Liability Companies and to Combat Abuses (Gesetz zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen [MoMiG]), dated 1 November 2008.

The UG is not an independent legal form but a subtype of the limited liability company. It may be formed with a share capital of EUR1 to EUR24,999, but is subject to specific statutory restrictions (e.g. contributions in kind may not be performed by an entrepreneurial company; mandatory allocation of one-quarter of the annual surplus into the capital reserve).

The UG generally is treated like a GmbH for tax purposes. By increasing the capital to at least EUR25,000, an UG can become a GmbH.

Stock corporation: *Aktiengesellschaft* (AG)

The AG is also a corporate entity with its own legal identity. The minimum share capital is EUR50,000. The management structure invariably consists of a management board and a supervisory board.

The management board is in charge of the management and representation of the AG. The members of the management board are appointed and removed by the supervisory board. The supervisory board only monitors the management board and represents the AG in relation to the management board.

The articles of association must stipulate that specific actions of the management board require the prior approval of the supervisory board.

The supervisory board must consist of at least three members or a higher number divisible by three. The shareholders elect the members. Where the AG has more than 500 employees, one-third of the members of the supervisory board must be elected by the employees. In AGs with more than 2,000 employees, employees have the right to elect one-half of the supervisory board members. Generally, the shares in AGs are certified.

In contrast to the GmbH, AG shares need not be transferred in notarized form and can be traded on the stock exchanges. The shareholders control the distribution of at least 50 percent of net earnings.

General partnership (oHG), limited partnership (KG), limited partnership with corporate general partner (GmbH & Co. KG)

In an oHG, no minimum capital is required and all partners are fully liable for the partnership's debts. In contrast, in a KG, there are general partners (*Komplementär*) with unlimited liability and limited partners (*Kommanditisten*) whose liability is restricted to their fixed contributions to the partnership. Although a partnership itself is not a corporate body, it may acquire rights and incur liabilities, acquire title to real estate and sue or be sued. Generally, all partners that are fully liable for the partnership's debts act as managing directors in contrast to the partners subject to limited liability. From a legal perspective, the transfer of shares in a partnership generally does not need to be recorded in the presence of a qualified notary.

The GmbH and Co. KG is a limited partnership in which the sole general partner is typically a GmbH, combining the advantages of a partnership with those of a limited liability corporation.

Other forms

The following, less common forms of association may also be encountered:

— private association (*Verein*)

— cooperative (*Genossenschaft*)

— foundation (*Stiftung*)

— partnership limited by shares (*Kommanditgesellschaft auf Aktien — KGaA*).

Associations and cooperatives can be useful in structuring cooperation among several independent parties. Foundations resemble common-law trusts to some degree. These three organizations are popular for non-profit activities but are not widely used for business purposes.

The partnership limited by shares is still rare but becoming more popular.

Commercial and non-commercial activity

German company and tax laws distinguish between trade and business activities (commercial activity) and other activities. Generally, the tax law assumes commercial activity where a company exercises a trade (which is not related to self-employment or passive asset management) for the purposes of making a profit. Capital gains generally are taxable where the property is sold as part of a commercial activity or is held by companies that are, by virtue of the law, trading companies.

Apart from a tax liability for capital gains, the main tax consequence of commercial activity is the liability for trade tax, which is imposed only on commercial enterprises. By virtue of their corporate legal form, company law and tax law deem the AG, the GmbH and the UG to be engaged in commercial activity.

Tax indemnities and warranties

In a share acquisition, the buyer is taking over the target company together with all related liabilities, including contingent liabilities. Therefore, the buyer normally requires more extensive indemnities and warranties than in the case of an asset acquisition.

Unlike the United States/Anglo-Saxon legal principle of caveat emptor (let the buyer beware), German law generally does not require the buyer to examine an entity they intend to purchase in advance. However, according to the German Civil Code (*Bürgerliches Gesetzbuch*), a buyer forfeits their rights and guarantee claims regarding a defect they are unaware of where gross negligence is involved. The non-performance of due diligence prior to the acquisition of an entity generally does not result in the buyer being grossly negligent. This is only the case where the buyer did not perform due diligence despite obvious defects of the target or suspicious facts. The buyer's decision on whether or not to perform a due diligence thus depends on an assessment of the individual circumstances.

By contrast, the vendor may have a pre-contractual duty to inform the buyer about certain defects of the target according to the German law principle of 'culpa in contrahendo'. This principle implies that a party with important information to which the other party does not have access must share it with the other party so that it can contract with sufficient knowledge of the facts. The extent of this obligation again depends on the individual case, particularly the value or significance of the transaction.

Tax losses

Use of pre-acquisition losses

In Germany, tax losses may be carried forward indefinitely for trade tax on income and personal or corporate income tax purposes. Personal or corporate income tax losses may also be carried back to the previous fiscal year, up to a maximum of EUR1 million.

The use of tax loss carry forwards is restricted by a minimum taxation scheme. Only EUR1 million plus 60 percent of the taxpayer's current year income in excess of EUR1 million can be offset against tax loss carry forwards. The restriction applies to both corporate income tax and trade tax.

The use of pre-acquisition losses is restricted by the general change of control rules. These rules lead to a partial forfeiture of loss carry forwards where more than 25 percent of the shares in a corporation are acquired by a buyer, a purchasing group or related parties within a period of 5 years. Where more than 50 percent of the shares are acquired, all loss carry forwards are forfeited. The rules apply to any direct or indirect change in the shareholder structure, so the acquisition of a multinational group at the top holding level may also lead to a forfeiture of losses in a German group company (see 'Recent developments').

The forfeiture of losses on a change of control, however, does not apply up to the amount of the domestic built-in gains of the loss company transferred. Therefore, tax loss carry forwards are only forfeited to the extent the losses carried forward exceed the transferee's domestic built-in gains in the business assets at the time of the detrimental change of control.

This provision covers share acquisitions from third parties as well as related parties. The latter case may become relevant where the criteria under the group exemption clause are not met (as discussed later in this report).

The built-in gains of the corporation's domestic (i.e. fully taxable) business assets prevent the forfeiture of current-year tax losses as well as tax losses carried forward. The built-in gains are determined by comparing the equity according to the tax accounts and the fair value of the shares of the loss company (which generally equals the purchase price).

A determination on a pro rata basis applies where not more than 50 percent of the shares in a loss-making corporation are transferred.

Built-in gains not subject to tax in Germany must be deducted (in particular, shares in corporations for which a capital gains exemption applies). A 2010 amendment to the exemption relating to taxable built-in gains eliminated the restriction to domestic business assets only so that foreign business assets subject to German taxation are taken into account as well. Moreover, where the equity of a loss-making entity is negative, the built-in gains are determined by comparing the equity according to tax accounts and the fair market value of the business assets (instead of the fair market value of the shares) to exclude built-in gains calculated in the shares that pertain to tax assets only.

An internal reorganization before 1 January 2010, such as the interposition of a new holding entity, could also trigger the general change of control rules. For reorganizations after 1 January 2010, the change of control rules for corporations have been eased by a new exception for share transfers within a group of companies. Under this exception, a change of ownership is not viewed as detrimental where 100 percent of the shares in the transferee or the transfer or are held directly or indirectly by the same person (i.e. wholly owned subsidiaries of a common parent) or the transferor or transferee itself. In a change from earlier legislation, the exemption also applies to trading partnerships as qualifying holding companies. A group exemption provision is not applicable where the transferring and acquiring entity belong to a group of companies but shares in the transferring and/or acquiring entity are held by outside (minority) shareholders.

The Tax Amendment Act 2015, dated 16 October 2015, extends the so-called 'group exemption' provision of the change-of-control rule in section 8c CIT. Previously, the rule did not cover transfers to or from the top holding company in otherwise privileged groups, leading to a forfeiture of carried forward losses on transfers of shares to the ultimate parent. The new law now provides an exemption from change-of-control rules where shares are transferred by or from the ultimate parent.

A turnaround exemption clause, introduced in 2009, states that the acquisition of shares in a loss-making company is not affected by the change of control rules if it serves the purpose of turning around the company's business. The turnaround (*Sanierung*) refers to a measure that aims to:

— prevent or abolish illiquidity or over-indebtedness

— preserve the essential business structures at the same time.

According to the rationale for the law, an acquisition serves the purpose of turning around the business where the acquisition takes place when the company in question faces potential or actual illiquidity or over-indebtedness. Further, to be considered an acquisition of shares for the purpose of turning around the business under the act, the company must show turnaround potential at the time of the acquisition.

The turnaround exemption does not apply where:

— the corporation had largely discontinued its operation at the time of the change in ownership

— a change in the line of business occurs within 5 years after the change in ownership.

The exemption clause was initially introduced as a temporary measure for share transfers taking place until 31 December 2009. This time limitation was later removed.

On 26 January 2011, the EU Commission ruled that this measure constitutes illegal state aid and therefore not in line with the requirements of the Common Market. While the proceedings of the German government against the ruling were dismissed as inadmissible by the General Court of the EU (EGC, 18 December 2012, t-205/11), numerous taxpayers have brought individual actions before the court that are still pending. In view of the potential ruling of the EU Commission, the German tax authorities had already suspended the application of the turnaround exemption and stayed all appeals against assessments not applying the turnaround exemption since April 2010, subject to a final court decision. The suspension was also implemented by the German legislator in December 2011.

Note that these change of control rules also apply to excess interest carried forward under the new earnings-stripping rules.

For partnerships, a direct acquisition of interests in a partnership limits the utilization of the trade tax loss carry forwards of the partnership or even triggers their partial or complete forfeiture. This can only be avoided by acquiring the partnership interest indirectly through another partnership. However, where the partners are corporate entities, even an indirect share transfer may lead to a forfeiture of tax losses.

Tax losses and interest carryforwards are retained on application despite a detrimental change in ownership within the meaning of section 8c CIT, provided that the corporation has maintained the same business operations since its formation or for at least 3 years. Additionally, as noted earlier, in this period of time until the end of the tax assessment period of the detrimental change in ownership, certain events must not occur. For example, during this period, the corporation must not:

— discontinue, suspend or change its business operations

— participate in a business partnership

— become a controlling entity in a tax group

— transfer business assets to the corporation for less than fair market value.

The previous occurrence of these events does not preclude application of section 8d CIT.

The law contains two exceptions. The first exception applies to losses incurred before a discontinuation or suspension of the business operations. These cases are captured where the corporation discontinued its business operations in the past and later commenced new business operations. The second exception provides for a preclusion where the loss-making company is the controlling entity in a tax group or participates in a business partnership at the beginning of the third tax assessment period preceding the tax assessment period of the detrimental change in ownership. This exception is designed to provide equal treatment for cases where the corporation established its status as a controlling entity in a tax group or business partnership before the 3-year observation period with cases where such status was established during the 3-year observation period.

In the event of a discontinuation, suspension or change in the business operations, the continuation-linked loss carryforward would be forfeited unless the hidden reserves clause is applicable. The same applies where the corporation participates in a business partnership or becomes a controlling entity, or business assets are transferred to the corporation under fair market value. Section 8d CIT is applicable to trade tax deficits analogously.

The revised rule took effect for the first time to detrimental changes in ownership after 31 December 2015.

Finally, the transfer of tax losses carried forward on mergers under the German Mergers and Reorganizations Tax Act has been abolished, so that all losses disappear in a corporate reorganization. Therefore, a step-up to the fair market or an interim value may be implemented to optimize loss utilization.

In addition, certain restrictions apply with regard to offsetting losses of the transferring entity and the receiving entity where a reorganization is implemented with retroactive effect. Generally, the income and business assets of the transferring corporate entity and the receiving entity are determined as if the business assets of the corporate entity had been transferred to the receiving entity at midnight on the date of the reorganization balance sheet. The restrictions on the offsetting of losses of the transferring entity at the level of the receiving entity were expanded to cover the offset of losses of the receiving entity. For reorganizations and contributions implemented after 6 June 2013, it is no longer permissible for the receiving entity to offset its losses or interest carried forward against income of the transferring entity generated in the period of retroactivity. Therefore, the income attributed to the receiving entity is fully taxed. The limit on offsetting losses does not apply where the transferring entity and the receiving entity are affiliated companies pursuant to Sec. 271 para. 2 German Commercial Code (*Handelsgesetzbuch* — HGB) before midnight on the date of transfer ('group clause').

Transfer taxes

See transfer taxes in this report's purchase of assets section.

Tax clearances

Tax clearances are recommended, especially in cases of complex acquisition structures, such as under the German reorganization law. A taxpayer can apply for a so-called 'binding ruling' with the competent tax authority regarding the application of tax laws to certain specific facts but not on the existence of certain facts. While the tax authorities have discretion to issue a tax ruling, they can only decline to issue a ruling in limited circumstances. The tax authorities are bound by binding rulings granted to the taxpayer where the taxpayer has executed the transaction as described in its application for the ruling.

The taxpayer must pay a fee with the application of the binding ruling unless the value of the dispute does not exceed EUR10,000. The maximum fee is currently capped at EUR109,736, which equals a value of dispute of EUR30 million.

Choice of acquisition vehicle

A foreign buyer may invest in a German target through different vehicles. The tax implications of each vehicle may influence the choice. Germany does not levy stamp tax or capital duty on funding a German company or branch.

Local holding company

A German holding company is typically used when the buyer wishes to ensure that tax relief for interest (e.g. resulting from a debt pushdown) is available to offset the target's taxable profits (see choice of acquisition funding) or taxable profits of other German companies already owned by the buyer within a tax-consolidation scheme (see group relief/consolidation).

Capital gains derived by a resident corporate shareholder are essentially 95 percent exempt from corporate income tax irrespective of the participation quota, holding period and source (domestic or foreign).

As of 1 March 2013, the 95 percent exemption only applies to dividend income of the resident corporate shareholder where the investment accounts for at least 10 percent of the share capital at the beginning of the respective calendar year. The abolition of the exemption from capital gains for respective minority shareholdings has been discussed as well but will stay in force for the time being.

For trade tax purposes, the 95 percent exemption of dividend income only applies where the investment accounts for at least 15 percent of the share capital or an equivalent participation quota in the assets at the beginning of the respective fiscal year.

Foreign parent company

A foreign buyer may choose to perform the acquisition itself, perhaps to shelter its own taxable profits with the financing costs related to the investment in the German target. Where the German target is a trading partnership, the financing costs of the foreign parent company in connection with the

acquisition of the partnership interest are generally tax-deductible at the level of the German partnership, subject to restrictions of the German earnings-stripping rules and a 25 percent add-back for trade tax purposes.

In order to prevent double deduction, the deduction for special business expenses is restricted insofar as they also reduce the tax assessment base in another state (section 4i IT). The deduction restriction does not apply where the income from which the expenses are deducted is doubly recorded, which may could occur, for example, in the absence of a double tax treaty or in the context of a tax credit. A double consideration of expenses and income also exists in any case, pursuant to the reasoning of the law, where expenses and income accrued in different states are considered at different times.

However, further dual consolidated loss rules may apply, and these rules are likely to be expanded with the OECD BEPS initiative.

For a German corporate subsidiary, dividend distributions are subject to withholding tax (WHT) at a rate of 25 percent, increased to 26.375 percent by a 5.5 percent solidarity surcharge. The dividend WHT may be reduced to 15.825 percent where the foreign parent company is not domiciled in a country that has a tax treaty with Germany. If there is a tax treaty or the EU Parent-Subsidiary Directive applies, the WHT may be reduced to tax treaty rates or to zero under German domestic tax law, provided the foreign parent company meets the requirements of the German anti-treaty shopping rules (see 'Anti-treaty shopping rules').

Where the foreign parent company invests through a German trading partnership, generally, the parent has a limited tax liability in Germany on its income from the partnership. A withdrawal of capital from the trading partnership is not subject to WHT.

In principle, a capital gain on disposal of the investment in the German company is subject to tax in Germany under German domestic tax law. Capital gains tax is mitigated by the German participation exemption rules for corporate shareholders, which principally provide for a 95 percent tax exemption, or by the partial income system for individual shareholders, which provides for a 40 percent tax exemption (previously 50 percent) where the German company is a corporate entity. Where individual shareholders hold less than 1 percent of the share capital as private property, a flat tax rate of 25 percent plus solidarity surcharge applies. A full capital gains tax exemption may be available on the disposal of shares in a company if the tax treaty allocates the right to tax capital gains to the foreign parent company's country of residence.

Non-resident intermediate holding company

Interposing an intermediate holding company generally implies an additional layer of taxation on funds repatriated to the investor. A non-resident intermediate holding company may be an option where the investor's country of residence taxes capital gains and dividends received from abroad. An intermediate holding company resident in another territory could be used to defer this tax and take advantage of a more favorable tax treaty with Germany.

The same German tax implications set out earlier for foreign parent companies apply to non-resident intermediate holding companies.

In terms of WHT relief, using a non-resident intermediate holding company is only more tax-efficient than a direct investment where the intermediate holding company meets the requirements of the German anti-treaty shopping rules. To the extent that the non-resident intermediate holding company does not derive its income from own business activities and lacks sufficient substance, the German anti-treaty shopping rules look through to its shareholder (see 'Anti-treaty shopping rules').

Where the shareholder meets the requirements, the intermediate holding company may claim the benefits of a tax treaty or German domestic tax law implementing the EU Parent-Subsidiary Directive. Where sufficient substance is not demonstrated, the benefits are limited to the extent that the ultimate shareholder could have claimed them.

Anti-treaty shopping rules

According to the German anti-treaty shopping rules, a foreign company has no right to complete or partial reduction of WHT pursuant to a tax treaty and the German Income Tax Act to the extent its shareholders would not be entitled to the refund or exemption if (a) they derived the income directly; and (b) the foreign company's gross earnings for the respective fiscal year are not derived from its own business activities and

— with regard to these earnings, there are no economic or other valid reasons for the interposition of the foreign company, or

— the foreign company does not participate in general commerce by means of a business organization with resources appropriate to its business purpose.

The CJEU ruled that the former German anti-treaty/anti-directive shopping rule was in violation of both the EU Parent-Subsidiary Directive and the freedom of establishment principle. A request for a preliminary ruling on the current provision is currently pending before the CJEU (C-440/17).

Local branch

As an alternative to directly acquiring the target's trade and assets, a foreign buyer may structure the acquisition through a German branch. Germany does not impose additional taxes (such as WHT) on branch profits remitted to an overseas head office. The foreign enterprise is taxable as a non-resident taxpayer on income derived from the PE in Germany. Thus, the branch's income is subject to German tax at normal corporate

and trade tax rates. Where the German operation is initially expected to make losses, a branch may be advantageous, because, subject to the tax treatment applicable in the head office's country, a timing benefit could arise from the ability to consolidate losses with the profits of the head office.

Unlike the disposal of a German subsidiary by a non-resident, which is 95 percent or 100 percent tax-exempt, a disposal of a German branch to a third party triggers capital gains tax, other than on capital gains relating to shares in corporations, which are in principle 95 percent tax-exempt.

Joint venture

Joint ventures can either operate though a corporate entity (with the joint venture partners holding shares in a German company) or an unincorporated entity (usually a German limited partnership — *Kommanditgesellschaft*).

Partnerships are generally considered to provide greater tax flexibility. For example, where the joint venture is expected to make initial losses, the partners should be able to use their shares of corporate income tax losses against their existing German profits. However, trade tax losses cannot be transferred and remain at the level of the partnership. Profits of a partnership can be repatriated free of German WHT. Further, financing costs for acquiring a partnership are tax-deductible at the level of the partnership, to the extent the financing costs are not deductible in another state (section 4i IT, discussed earlier). This approach allows for a debt pushdown without moving the debt itself to the joint venture or partnership level. However, any payments to the partners (e.g. management fees) are not tax-deductible at the partnership level. German real estate investments held by foreigners are often structured using partnerships because no German trade tax arises, provided the business qualifies as non-trading for tax purposes.

Choice of acquisition funding

A buyer needs to decide whether to fund the acquisition with debt or equity. The main concern is often to ensure that interest on funding can be set off against the target's profits to reduce the German effective tax rate. Tax-deductibility depends on the acquisition vehicle's legal form and place of residence, as well as the legal form of the target.

Debt

The advantage of debt is the potential tax-deductibility of interest (see deductibility of interest), because the payment of a dividend is not tax-deductible at the level of the distributing entity. Where debt is used, the buyer must decide which company should borrow and how the acquisition should be structured. To allocate the cost of debt efficiently, there must be sufficient taxable profit against which interest payments can be offset. The following comments assume that the buyer wishes to set off the interest payments against the German target's taxable profits. However, consideration should be given to whether relief would be available at a higher rate in another jurisdiction.

Usually, a German corporation is used as the acquisition vehicle for a share acquisition, funding the purchase price with debt either from a related party (e.g. shareholder loan) or directly from a bank. Dividends received from domestic shareholdings are generally tax-exempt for trade tax purposes if the investment amounts to at least 15 percent and is held from the beginning of the fiscal year. A respective exemption applies for corporate income tax purposes if the investment accounts for at least 10 percent of the share capital at the beginning of the respective calendar year. However, 5 percent of any dividend received is treated as non-tax-deductible, which effectively reduces the dividend exemption to 95 percent. On the other hand, any business expenses, particularly interest expenses related to German-sourced dividend income, are fully tax-deductible for corporate income tax purposes (for discussion of restrictions on interest expenses and the add-back rules for trade tax purposes, see deductibility of interest).

The most common way to deduct interest expenses and offset them against the target's taxable income is an acquisition through a leveraged acquisition vehicle, followed by the establishment of a tax-consolidation scheme (*Organschaft*). A debt pushdown into the target directly may be achieved by merging the target into the acquisition vehicle or vice versa. Otherwise, interest expenses would remain structurally non-deductible because of the acquisition vehicle's lack of taxable income. In an asset deal, such an offset is automatically achieved where the buyer of the assets/going concern is provided with the acquisition funding.

Due to the fiscal transparency of partnerships for German corporate income tax purposes, any interest on debt taken out to acquire an interest in a German partnership is tax-deductible at the level of the target, rather than at the level of the acquisition vehicle. Thus, the acquisition of a partnership often results in an automatic debt pushdown for German tax purposes.

If the interest cannot be offset immediately (i.e. there are insufficient taxable profits), the resulting losses can be carried forward for German corporate income and trade tax purposes. In addition, it is possible to carry back losses of up to EUR1 million for German corporate income tax purposes.

Depending on the existing structures of the buyer and target groups, it may be possible to introduce leverage into Germany after (rather than at the time of) the acquisition, such as by way of a recapitalization.

Deductibility of interest

Tax-efficient debt-funding of acquisitions in Germany is restricted by earnings-stripping rules.

These rules generally limit the deductibility of net interest expenses (interest expense in excess of interest income)

to 30 percent of EBITDA for tax purposes. Unlike traditional thin capitalization or transfer pricing restrictions applicable in many European countries, this restriction applies to any kind of interest expense, irrespective of whether it is derived from intercompany financing or third-party debt. The rules only apply to net interest expense exceeding EUR3 million in the assessment period.

To assess whether the earnings-stripping rules result in a restriction on interest deductions, the EBITDA for tax purposes must be accurately modelled in each case. The German generally accepted accounting principles (GAAP) results need to be decreased by tax-free income, such as dividends, capital gains and exempt foreign-sourced profits, to determine the allowable amount of interest.

Any interest in excess of the 30 percent threshold is non-deductible. Excess interest may be carried forward to future tax years but is subject to change of control restrictions, which may lead to a (full or partial) forfeiture of interest carryforwards on a transfer of shares in the respective company (as further discussed under tax losses in the purchase of assets section earlier in this report).

Companies wishing to deduct more interest expense than allowed under these restrictions may be able to take advantage of the so-called 'escape clause'. To qualify, the taxpayer must be able to demonstrate to the German tax authorities that the equity ratio (equity/balance sheet total) of the company is not more than 2 percent (increased from 1 percent by the Economic Growth Acceleration Act for 2010 and later assessment periods) lower than the equity ratio of the consolidated group of which the company is a member. In other words, debt financing must not exceed that of the group as a whole. Specific rules apply to the calculation of the equity ratio for this purpose, and there is a restriction on the use of debt granted or secured by related parties from outside the consolidated group (tainted debt). The interest on such debt must not exceed 10 percent of the total net interest expense for each entity in the group. Interest expense in excess of 10 percent on tainted debt is subject to the 30 percent EBITDA restriction.

Although the German tax authorities issued a decree in July 2008 on the application of the earnings-stripping rules, the rules are difficult to apply because it is not clear how to determine the correct consolidation level, the applicable accounting principles, or the equity ratio for tax purposes, taking into account certain adjustments and add-backs. Structuring a transaction with a borrowing ratio that leads to interest expenses in excess of the 30 percent EBITDA rule requires careful analysis of whether the conditions of the escape clause can be met.

Where the net interest expenses are subject to the 30 percent EBITDA threshold but less than 30 percent of the tax EBITDA, the unused tax EBITDA provides for an additional interest deduction in future years in which the net interest expenses exceed 30 percent of the current tax EBITDA. Such EBITDA carry forwards are limited to a period of 5 years and must be assessed separately. An EBITDA carry forward is not allowed in years in which an exemption from the earnings-stripping rules applies. Taxable EBITDA is subject to full or pro rata forfeiture where the business of that company is transferred as a whole or, in certain cases of group reorganizations, according to German reorganization tax law. EBITDA carried forward is not forfeited on a detrimental change of control (i.e. a purchase of more than 25 percent of the shares in a company). Generally, the provision applies for business years ending after 31 December 2009.

For trade tax purposes, the deductibility of interest is further limited by an add-back of 25 percent of any deductible interest expense that exceeds EUR100,000 (together with certain other add-backs).

Currently, a German Federal Constitutional Court decision is pending on whether the earnings-stripping rules are in breach of the constitutional principle of equality.

Withholding tax on debt and methods to reduce or eliminate it

Generally, interest payments to lenders are not subject to German WHT. However, non-resident lenders are subject to non-resident taxation in Germany where the debt provided is secured by, for example, land charges on German real estate owned by the borrower/ target group and no relief can be claimed under the relevant tax treaty. Where a lender fails to qualify for relief, all interest income is subject to corporate income tax in Germany at a rate of 15.825 percent (including solidarity surcharge).

Checklist for debt funding

— Consider whether the level of taxable profits of the German entities would allow effective tax relief for interest payments and whether a tax deduction may be available at higher rates in other jurisdictions.

— Analyze the debt capacity of the German (target) entities based on projections of EBITDA for tax purposes. Explore the potential applicability of the so-called 'escape clause' under the earnings-stripping rules.

— Explore whether a debt pushdown should be completed by a tax group scheme (*Organschaft*) or by way of a merger or other measures.

Equity

A buyer may use equity to fund the acquisition. German tax law imposes no capital or stamp duty.

However, Germany would levy 26.375 percent WHT (including solidarity surcharge) on dividends paid by a German company. The WHT may be avoided through the EU Parent-Subsidiary Directive or reduced under a tax treaty or domestic law, provided applicable conditions are met, particularly the minimum participation, holding period and substance

requirements. Dividend payments are not tax-deductible in Germany.

Although equity offers less flexibility should the parent subsequently wish to recover the funds it has injected, the use of equity may be more appropriate than debt in some situations, particularly where the target (group) is loss-making or the deductibility of interest expenses has already reached its limit under the earnings-stripping rules. Therefore, a tax-efficient structure normally requires an appropriate mix of debt and equity so that the interest expense remains deductible under the earnings-stripping rules. In addition, there may be non-tax reasons for using equity.

Reorganizations

The discussion thus far has focused on the purchase of an entire business for cash. Where only part of a business is targeted and the seller refuses to agree to an asset sale, the provisions of the new German Reorganization Law, discussed later in the report, may permit a hive-down of the targeted assets into a subsidiary, the shares of which can then be sold. Accordingly, where two businesses are to be combined, the merger provisions may permit the combination to be structured as a share-for-share exchange without triggering an immediate tax liability. Due to several anti-avoidance rules, a tax-exempt reorganization followed by a disposal of shares in the company involved may lead to adverse tax consequences if the disposal date is close to the reorganization date. The reorganization may become retroactively subject to tax as a result.

German Reorganization Tax Law was amended to facilitate cross-border reorganizations within the EU. Now the act covers not only reorganizations carried out under German Reorganization Law but also reorganizations in other EU jurisdictions that are comparable to reorganizations under German law. Transactions involving companies from non-EU and non-EEA countries usually still lead to immediate taxation of the transaction at both company and/or shareholder/partner level.

Generally, the Reorganization Tax Law provides for all reorganizations to be carried out at fair market value, leading to the taxation of hidden reserves. Where Germany has the right to tax the transferred assets, reorganizations can only be effected at book value on written application. In such cases, an interim value (below fair market value) may be chosen in order to utilize existing tax losses carried forward, subject to the minimum taxation rules, by offsetting them against any profits on reorganization.

One of the most significant privileges of reorganizations under the Reorganization Tax Law is that most reorganizations can be carried out with a retroactive effect of up to 8 months for tax purposes. For example, the legal procedures of the reorganization can be carried out up to 31 August 2018, if the effective date of the reorganization for tax purposes was 31 December 2017.

Merger of a German corporation into a German partnership

A merger of a corporation into a partnership can be carried out at book value so that no gain is recorded at the level of the transferring corporation, but the German tax authorities retain their right to tax any hidden reserves in the assets of the transferring corporation.

At the shareholder level of the transferring corporation, different effects should be considered:

— Any tax-effective depreciation on the shares in the transferring corporation is reversed, leading to a taxable profit. Such profit is 95 percent tax-exempt for corporate shareholders and 40 percent tax-exempt (50 percent before 2009) for individual shareholders.

— Retained earnings of the transferring corporation are treated as deemed dividend distributions and taxed at the shareholder level. Such dividends are 95 percent tax-exempt for corporate shareholders. They are also subject to 26.375 percent WHT (including 5.5 percent solidarity surcharge), which is generally creditable by domestic shareholders.

— For tax purposes, the shares in the transferring corporation generally are deemed to be contributed to the partnership. The replacement of the shares in the transferring corporation with the assets of the corporation due to the merger may then lead to a profit or loss on merger. Transaction costs and the deemed dividend distribution also may be deducted when calculating the merger profit or loss. A merger profit is 95 percent tax-exempt at the level of a corporate partner in the assuming partnership, but any loss on takeover is not tax-deductible.

Since a partnership is transparent for German income tax purposes, Germany's right of taxation could be restricted on some mergers, for example, where the assuming partnership has non-resident partners that are only subject to a limited tax liability in Germany. Following the merger, any operating profit or capital gain is taxable at the level of the non-resident partner, so a tax treaty could restrict the right of taxation.

However, in most cases, the right of taxation remains with Germany to the extent the business assets constitute a PE.

Tax losses, interest and EBITDA carried forward, as well as current-year losses, are not transferred to the receiving partnership. Thus, such losses may only be offset against any merger profit resulting from a transfer of the assets at fair market value or an interim value. Normally, the tax losses carried forward are not entirely used since the tax losses carried forward for corporate income tax and trade tax purposes usually differ. Moreover, the set-off of tax losses carried forward is further restricted by the minimum taxation rules. In addition, any interest carried forward resulting from

the limitations of the earnings-stripping rules is not transferred to the receiving entity.

Merger of a German corporation into another German corporation

A corporation can be merged into another by compensating the shareholder(s) of the transferring entity with new shares in the receiving entity or, in exceptional cases, without any compensation. A formal liquidation of the transferring entity is not required. On the merger, the transferring entity can increase the cost base of its assets, including self-created intellectual property. The increase in the cost base triggers taxable income at the level of the transferring entity and increases the depreciation base at the level of the receiving entity. In most cases, a merger gain (i.e. a gain resulting from an excess of the value of assets received over the shares held in the transferring entity) at the level of the receiving entity is tax-free. However, in the case of an upstream merger where a subsidiary merges into the parent company, the merger gain is only 95 percent tax-exempt. In all cases, a merger loss is not tax-deductible.

Any previous write-downs of shares in the transferring company must be reversed. Where these write-downs were tax-deductible (i.e. for write-downs prior to 2002), the reversal is subject to corporate income and trade taxes in full. Write-downs occurring after 2001 are not tax-deductible, so the reversal is 95 percent tax-exempt for corporate income and trade tax purposes.

Tax losses, interest and EBITDA carried forward (earnings-stripping rules) by the transferring entity are forfeited on the merger (see merger of a German corporation into a German partnership).

Contribution of assets into a German corporation in return for new shares

When the transferring entity receives new shares in the receiving entity, the following assets can be transferred to a German corporation under the German Mergers and Reorganizations Tax Act:

— assets and liabilities that constitute a branch of activity (*Betrieb or Teilbetrieb*), which can be categorized as such where they have a certain degree of independence and are potentially capable of functioning as an independent business

— an interest in a partnership

— a stake in a corporation.

Such a transfer is generally performed at fair market value, triggering a taxable gain or loss. However, the contribution of a branch or a partnership interest can be done at cost. This does not trigger additional tax costs where the following requirements are met:

— The contributed assets are subject to German corporate income tax at the level of the receiving entity.

— For contributions effected before 2015, the liabilities contributed do not exceed the assets contributed. For contributions effected or agreed in 2015 and later years, the liabilities contributed or any compensation other than shares does not exceed EUR500,000 or 25 percent of the book value of assets contributed

— Germany's taxation rights on the contributed assets are not excluded or limited as a result of the contribution.

The contribution of a stake in a corporation may be effected tax-neutrally if the receiving entity owns the majority of the voting rights in the contributed corporation after the contribution. Any existing shareholding is included when considering this condition.

A tax-free contribution may be later subject to partial, retroactive taxation where, within 7 years following the contribution, either the shares granted in exchange for the contributed assets or the contributed shares themselves are sold. However, the sale of the contributed shares does not lead to retroactive taxation where the contributing entity is a corporation that could have disposed of the shares tax-free anyway.

The taxable gain is decreased pro rata by one-seventh for each year that elapses from the time of the contribution to the time of the sale. The taxpayer must demonstrate to the tax authorities by 31 May of each year that the shares were not sold during the past year. A failure to provide such evidence to the tax authorities in good time leads to a deemed share transfer and retroactive taxation on a pro rata basis.

Demerger

In addition to the aforementioned contributions, a branch of activity, interest in a partnership or a 100 percent stake in a corporation can be contributed in return for new shares in the transferee or, in exceptional cases, without any compensation. The main differences between this and the previously discussed contribution are that new shares can be granted to the shareholder of the transferring entity and this scheme is solely applicable to corporations. Generally, three models are possible:

— In a split-up, an entity transfers all of its assets and liabilities to two or more receiving entities, either pre-existing or created for this purpose. The transferring entity is dissolved without being liquidated, and the owners of the transferring entity take ownership interests in the receiving entities in return for their dissolved interests.

— In a split-off, an entity transfers part of its assets and liabilities to one or more receiving entities, either pre-existing or created for this purpose. The transferring entity is not dissolved. The owners of the transferring entity take shares in the receiving entity in return for surrendering their indirect ownership rights in the property transferred. Split-offs include transactions in which the owners of the transferring entity all receive pro rata ownership rights in

the receiving entity (sometimes called spin-off). Split-offs also include transactions in which certain owners of the transferring entity surrender all or part of their interest in this entity in return for an increased interest in the receiving entity.

— In a hive-down, an entity transfers part of its assets and liabilities to one or more receiving entities, either pre-existing or created for this purpose, and in return takes ownership rights in the receiving entities.

These types of transaction are generally carried out at fair market value but can also be achieved tax-free subject to certain conditions. For split-offs, both the assets and liabilities retained and those transferred must constitute self-contained businesses, interests in trading partnerships, or 100 percent ownership of corporations to ensure that the split-off is performed tax-neutrally at book value. The split-off of other assets must be carried out at fair market value, leading to a capital gain. For split-ups and hive-downs, the same applies to the assets transferred. However, where shares in a corporation are being hived down to another corporation, it is enough that the receiving corporation holds a majority of the first corporation's voting shares after the reorganization (see 'Contribution of assets into a German corporation in return for new shares').

Complete continuity of ownership between the transferring corporation and the receiving entity (i.e. no separation of shareholder groups) is a condition of tax-free treatment in split-offs and split-ups, unless the shareholders in the transferring corporation have held their shares for at least 5 years. However, it is not necessary for all shareholders of the transferring corporation to take pro rata ownership interests in the receiving entity. The interest retained in the transferring entity can be reduced in return for an increased interest in the receiving entity and vice versa. Unanimous shareholder approval is required.

Where, within 5 years of a split-up or split-off, interests in the entities representing more than 20 percent of the value of the original interests in the transferring entity are conveyed to third parties, the entire reorganization is retroactively subject to tax.

Where a corporation is divided by a split-up, all loss carry forwards are forfeited. In a split-off, tax losses carried forward are not transferred to the receiving entities and some existing tax losses are forfeited.

Contribution of assets into a German partnership

Under German Reorganization Tax Law, all the shares in a corporation, self-contained businesses or interest in a partnership can be contributed tax-free, provided Germany's taxation rights in relation to these assets is not removed or limited. While the contribution of shares into a corporation can be tax-neutral, provided the receiving entity owns the majority of the voting shares following the contribution, the contribution of shares into a partnership is eligible for tax-neutral treatment under this regime only if all the shares are transferred.

As of 31 December 2014, the same restrictions that apply on the contribution of assets into a corporation apply where the contributor receives compensation other than an equity interest in the receiving partnership. Such additional compensation must not exceed EUR500,000 or 25 percent of the book value of assets contributed.

Outside the scope of the Reorganization Tax Law, a transfer of single assets (including individual non-qualifying shares in a corporation) between two businesses owned by the same taxpayer or the attribution of assets to a partnership for tax purposes (*Sonderbetriebsvermögen*) is possible according to the Income Tax Act, section 6 par. 5. According to German tax law, a transfer of shares by a partner to the partnership of which they are a member is also possible at tax book values. Other than the reorganization schemes described earlier, such a transaction is ineligible for retroactive application and the legal benefit of universal succession is not available. Consequently, contracts and licenses, etc., can only be transferred with the consent of the counterpart or regulator.

Change of legal form

The German Reorganization Act and Reorganization Tax Act allow for the conversion of a corporation into a partnership and vice versa. From a tax perspective, the conversion of a corporation into a partnership triggers the same tax consequences as the merger of a corporation into a partnership, as described earlier. The conversion of a partnership into a corporation is treated as a contribution of a branch of activity into a corporation in return for new shares, as noted earlier.

Hybrids

Consideration may be given to hybrid financing — that is, using instruments treated as equity for tax purposes for one party and as debt (giving rise to tax-deductible interest) for the other. Various hybrid instruments and structures were devised to achieve an interest deduction for the borrower with no income inclusion for the lender. However, legislative changes made in 2013 deny the tax-effectiveness of certain double dip structures, particularly hybrid financing structures. Further restrictions are expected to apply with the implementation of the OECD BEPS initiative.

Discounted securities

The tax treatment of securities issued at a discount to third parties normally follows the accounting treatment. As a result, the issuer should be able to obtain a tax deduction for the discount accruing over the life of the security. An advantage of discounted securities is that discount, unlike interest, does not give rise to WHT.

Deferred settlement

An acquisition often involves an element of deferred consideration, the amount of which is based on the business's

post-acquisition performance and can only be determined at a later date. Under German tax law, the right to receive an unknown future amount is not regarded as an asset that must be valued upfront for German tax purposes. Instead, any consideration is treated as a retroactive adjustment of the initial consideration paid, and the tax calculation of both seller and buyer is amended retroactively for the deferred consideration received.

Other considerations

Concerns of the seller

The tax position of the seller can be expected to significantly influence any transaction. Due to differences in the tax treatment of asset and share sales, owners of corporate target entities generally are less inclined to sell the entity's assets than its shares.

Asset deal

The taxation of capital gains depends on the legal form of the seller and the type of asset disposed.

Where the seller is an individual who sells their whole business, the capital gain may be subject to a favorable tax regime. For a corporation, capital gains are generally fully taxable; however, where the business assets include shares, the 95 percent participation exemption applies on the sale of the shares.

The new provisions on the transfer of contingent losses allow the seller to realize built-in losses subject to certain limitations. While immediate deduction of realized built-in losses is allowed on the transfer of an entire business or partnership interest, built-in losses that are realized due to the transfer of a liability in other cases generally may not be fully deducted in the year of transfer but must be spread over a period of 15 years. These rules are especially relevant if, within a business transfer, existing pension obligations are transferred.

Disposal of a partnership

The taxation of a capital gain incurred on the disposal of a partnership interest depends on the type of partner concerned, that is, whether the partner is an individual or a corporate entity and, in the case of a disposal by an individual, whether their interest is sold fully or partly.

Where a partner sells their whole interest in the partnership, the resulting capital gain is not subject to trade tax if the seller is an individual. Additionally, an individual can apply for the same tax relief as described earlier with respect to the transfer of a going concern business by means of an asset deal. If only part of the partnership interest is sold, trade tax becomes due. In addition, none of the tax reliefs granted on the disposal of the whole interest are usually available when disposing of part of an interest (i.e. neither the limited tax exemption nor the reduced average tax rate applies).

For corporate partners, the capital gain is subject to corporate income tax and trade tax, irrespective of whether the participation is sold in whole or in part.

For corporate members, the part of the capital gain from the disposal of a partnership interest attributable to a participation in shares held by the partnership is taxed in the same way as if the shares were held directly by the seller (see next section).

Disposal of shares

German taxpayers enjoy certain tax exemptions on capital gains realized on the sale of shares in a corporation:

— Sellers who are resident or non-resident individuals can exclude 40 percent (50 percent pre-2009) of the gain realized for income tax purposes and, if applicable, for trade tax purposes (40 percent exemption).

— Individual sellers holding less than 1 percent of the shares in the company as private property are subject to a flat tax rate of 25 percent plus solidarity surcharge.

— Resident and non-resident corporate sellers can generally exclude their entire gains for corporate income and trade tax purposes (100 percent exemption). The same applies where the shares are held by a German branch of a foreign company or a German partnership with a corporate partner. However, 5 percent of the capital gain is deemed to be a non-deductible business expense for corporate sellers, effectively reducing the 100 percent exemption to 95 percent. While current expenses, such as financing costs, are tax-deductible, expenses incurred on the sale of shares reduce the amount of the capital gain, so they are only 5 percent tax-deductible.

Generally, a minimum interest, holding period or tax treaty protection is not required to qualify for these exemptions. However, within a 7-year holding period following a tax-free reorganization, a sale may have adverse tax consequences under German reorganization tax law (see earlier in the report). Banks and other financial institutions that sell stocks held for short-term trading purposes cannot benefit from the capital gains exemptions because receipts are considered trading income.

The capital gains tax exemption does not apply to the disposal of shares held by life and health insurance companies.

Company law and accounting

Under German commercial law, International Financial Reporting Standards (IFRS) can be substituted for German GAAP as reporting standards for listed and non-listed companies. However, German GAAP are mandatory for statutory financial statements, particularly as the basis for the distribution of dividends, for insolvency law and for tax reasons. German reorganization law is mainly laid out in the so-called '*Umwandlungsgesetz*' (UmwG), which sets out the rules for commercial law and the accounting treatment for mergers (*Verschmelzungen*) as well as demergers (spin-offs, split-offs, carve-outs) and conversions.

As for M&A transactions, a business combination (which IFRS define as the bringing together of separate entities or businesses into one reporting entity) may be categorized as either a merger or an acquisition. In essence, a combination is regarded as a merger where it effects a pooling of business interests (i.e. where one company's equity is exchanged for equity in another company) or where shares in a newly incorporated company are issued to the merging companies' shareholders in exchange for the equity, with both sides receiving little or no consideration in the form of cash or other assets.

German company law and accounting standards allow for various M&A methods. Generally, for mergers, companies have the choice of keeping current book values or changing to fair values according to German reorganization law in their statutory financial statements. Acquisitions are accounted for based on the contribution made in exchange for economic control over the company or over assets and liabilities that constitute a branch of activity. In contrast to German GAAP, merger accounting is not allowed under IFRS; all business combinations must be accounted for as acquisitions.

One of the main practical distinctions between acquisition accounting and merger accounting is that acquisition accounting may give rise to goodwill. The net assets acquired are brought onto the consolidated (share deal) or statutory (asset deal) balance sheet at their fair values, and goodwill arises to the extent that the consideration paid exceeds the sum of these values. Under IFRS, goodwill is not amortized over its useful economic life (impairment-only approach). Under German GAAP, goodwill in the consolidated financial statements is amortized on a systematic basis over its estimated useful life. For practical reasons, a useful life of 15 years, as defined by German tax law, is usually applied to amortize goodwill in both statutory financial statements under German GAAP and the tax balance sheets. Acquisition accounting principles also apply to purchases of trade and assets, with any goodwill and fair value adjustments appearing on the buyer's own balance sheet. In merger accounting, goodwill does not arise. Any remaining difference is treated as a capital contribution or as a merger gain or loss, depending on the shareholder resolution.

Another important feature of German company law concerns the ability to pay dividends. Distributions of profit may be made only out of a company's distributable equity under German GAAP (e.g. retained earnings or available capital reserves). Thus, for groups, the distributable equity reserves must be determined by aggregating the corresponding statutory German GAAP accounts of the holding company and its subsidiaries separately, rather than by simply looking at the equity reserves of the group at consolidated level. Regardless of whether acquisition or merger accounting is adopted in the group accounts, the distribution of pre-acquisition profits of the acquired company may be restricted.

Additionally, distributions recorded in the company's accounts must meet certain legal capital maintenance rules. Violation of these rules triggers a personal liability for management and shareholders. In particular, these rules may need to be applied where simple upstream loans are made to the parent company instead of dividend payments. Previously, the scope of these rules was much wider. Even now, it remains important that upstream loans are not impaired at grant date and that management continuously monitors the credit-worthiness of the borrower. Share capital increases, particularly payments in kind rather than cash, must also meet legal requirements for capital maintenance. Otherwise, the management and shareholders may become personally liable.

Germany does not generally impose government controls or restrictions on investments in assets and business entities or on capital movements into or out of Germany. However, the German foreign trade act (*Außenwirtschaftsgesetz*) allows for a prohibition of acquisitions regarding more than 25 percent of voting rights by non-European investors if public order or security are endangered. Due to a restrictive application, the majority of transactions is not affected by such prohibitions. Foreign investors can obtain legal certainty by obtaining a clearance certificate before a relevant acquisition. Further restrictions exist for investments in military weapons, including dual-use technologies.

In addition, foreign trade regulations (*Außenwirtschaftsverordnung*) require reporting certain flows of capital for statistical purposes.

Germany has anti-trust legislation to safeguard free competition. M&A transactions above a certain size (essentially, involving companies or corporate groups with a joint worldwide turnover exceeding EUR500 million) and including at least one entity with a turnover exceeding EUR25 million in Germany and another with a turnover exceeding EUR5 million in Germany must be registered with the federal cartel authority regardless of the nature of the business. The federal cartel office can prohibit or restrict such transactions if it considers them to be detrimental to competition. EU anti-trust laws may pre-empt German anti-trust laws or add to them, depending on the transaction.

When planning an M&A transaction, labor law considerations should be taken into account. Under a provision in force in one form or another throughout the EU, the buyer of a business automatically takes over all employment contracts associated with it. It makes no difference in this respect whether shares or assets are purchased, although difficult questions arise when not all assets of a business are acquired, such as the acquisition of one of several business divisions (branches of activity). Continuation of the employment contracts does not in itself prevent immediate downsizing following the acquisition, but this must be conducted in accordance with general German labor law legislation, which, compared with that of many countries, favors employees.

Further, Germany has an employee codetermination/participation system for virtually all businesses. At the business level, in companies with at least five employees, employees can elect a works council (*Betriebsrat*). The works council has a variety of rights to be informed and heard on personnel and other intracompany matters. If a works council exists, some decisions, such as terminations, may also require prior consent of the works council.

At the company level, employee co-determination provisions require companies with 500 or more employees to establish a supervisory board if they do not already have one according to their articles of association. The employees have the right to elect one-third of the supervisory board members, or 50 percent of the supervisory board members in companies with more than 2000 employees. Advocates of this system regard it as at least partially responsible for the traditionally good German management-labor relations and relatively low level of strike activity. Foreign owners unfamiliar with supervisory boards sometimes consider this practice to be unusual.

Group relief/consolidation

Generally, each entity is taxed on a standalone basis, unless the entities constitute a consolidated tax group. Entities that are part of such a consolidated group are taxed together as a single body (*Organschaft*).

There are three types of tax consolidation in Germany: VAT consolidation, trade tax consolidation and corporate income tax consolidation. In all three cases, group members (controlled entities) are consolidated under a group leader (controlling entity). All types of consolidation require the financial integration of the group members.

Financial integration requires at least a direct or indirect majority of the voting rights of the controlling entity in the controlled company.

Only European stock corporations (*societas Europaea*), stock corporations, partnerships limited by shares and, subject to certain requirements, other corporations (particularly GmbH) established in an EU/EEA member state whose place of management and control is in Germany qualify as potential group subsidiaries. Due to the transparency of a partnership for corporate income tax purposes, the partnership's income is attributed to its partners and taxed in their hands. Therefore, for a partnership, corporate income is effectively consolidated.

Corporate income tax and trade tax consolidation require only the financial integration from the beginning of the fiscal year and a signed profit and loss pooling agreement between the group member and the group leader. This agreement is subject to various formal requirements and must actually be performed. Further, the agreement is enforceable by creditors (e.g. to force the group leader to transfer funds to a group member to cover its losses).

The group leader can be any individual, corporation or partnership engaged in a commercial enterprise with a PE in Germany. However, the shares in the controlled subsidiary have to be allocated to the German PE for the tax group to be recognized.

Losses sustained by group members after the effective date of consolidation are attributed to the group leader for trade and corporate income tax purposes. Pre-consolidation corporate income tax and trade tax losses are not affected by the consolidation and remain within the group member for use after the tax consolidation is terminated (e.g. by termination of the profit and loss assumption agreement).

For VAT purposes, consolidation requires the financial, organizational and economic integration of the group members into the group leader:

— Organizational integration requires the controlling entity to be able to assert management influence on a group member (e.g. where the same persons manage both companies or the group member contractually yields management authority to the group leader).

— Economic integration requires a substantial economic relationship between the activities of the group members and the group leader, ideally such that the group member functions economically like a branch of the group leader. This is often the most difficult of the three requirements to meet, especially where the intended group leader is a pure holding company.

For VAT purposes, the tax consolidation automatically becomes effective when these requirements are met.

Transfer pricing

Where an intercompany balance arises between the buyer and the target after the acquisition, failure to charge interest on the balance may give rise to transfer pricing problems in the relevant jurisdiction. For example, where the balance is owed to the target, the tax authorities could impute interest on the balance if interest is not charged at an arm's length rate. Failure to charge fees, such as for cross-guarantees provided where the German target is the guarantor, may give rise to transfer pricing adjustments.

Dual residency

There may be advantages in seeking to establish a dual resident company, such as by benefitting from rules that are not followed in other jurisdictions (e.g. special business expenses in the case of partnerships).

Foreign investments of a local target company

The CFC anti-avoidance legislation is designed to prevent German companies from accumulating profits offshore in low-tax countries. Unless the offshore lower-tier company is carrying out certain acceptable activities or meets other specific conditions, its profits are apportioned and allocated to the German parent company and are subject to German tax.

Therefore, the structure of the potential target should be reviewed for CFC risks in advance.

Comparison of asset and share purchases

Advantages of asset purchases

— Direct allocation of the transaction financing to the acquired assets.

— Step-up to a higher depreciation base and goodwill amortization.

— Assumption of business-related liabilities only, although certain liabilities are unavoidable under the German Civil Code (BGB), section 613a, the German Commercial Code (HGB), section 25, and the General Tax Act (AO), section 75.

— Easy integration of profitable target operations into the loss-making company in the buyer's group, permitting future offset of profits and losses.

— Selective acquisition of only those assets that are desired; debt-free acquisition of the business.

Disadvantages of asset purchases

— Approval of partners/shareholders possibly required.

— Legally more complicated due to the need to specify assets acquired, regulate delivery, arrange for continuation or renegotiate contractual relationships, etc.

— Possible difficulties in transferring certain pension obligations to the buyer.

— Need to renew licenses and permits associated with the business.

— Higher capital outlay if purchased debt-free.

— Potentially higher capital gains tax for the seller.

— Likely to be subject to VAT unless the whole business is transferred.

— RETT base may be higher.

Advantages of share purchases

— Greater legal simplicity; no need to assume contracts or re-apply for licenses and permits.

— Potential 95 percent capital gains tax exemption for the seller.

— Potential integration of target corporation into existing tax-consolidated group.

— For partnership interests, double dips may be possible. Also, step-up for tax purposes available.

Disadvantages of share purchases

— Target business in a corporation form (i.e. where the target is a form of tax-transparent partnership, an interest purchase generally is treated as an asset deal for tax purposes).

— Tax depreciation is unaffected by the value of the purchase price (unchanged historical asset depreciation values).

— Acquisition of all business-related liabilities.

KPMG in Germany

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Greece

Introduction

Greek legislation provides a number of tax incentives for mergers and acquisitions (M&A) of business entities for the purpose of creating larger, more efficient entities.

For cross-border M&As, Greece enacted Law 2578/1998 (amended by Law 3517/2006) to implement the European Union (EU) Merger Tax Directive (Directive 90/434/EU as amended by Directive 2005/19). However, due to the lack of a company law framework for cross-border mergers until the end of July 2009, the relevant provisions of Law 2578/1998 were not practically applicable, except for those relating to the exchange of shares, transfer of assets and cross-border merger for the formation of a European company.

On 28 July 2009, Law 3777/2009 on cross-border mergers of companies was enacted, implementing the provisions of EU Directive 2005/56 of 26 October 2005 in relation to cross-border mergers of companies of different member states, with the purpose of expanding the scope for EU enterprises to restructure within the EU market.

Further, Law 4172/2013 (Income Tax Code — ITC) incorporated the provisions of the EU Merger Directive 2009/113, which provides a common system for the taxation of company reorganizations.

This report addresses three fundamental decisions that face a prospective buyer.

— What should be acquired: the target's shares or its assets?

— What will be the acquisition vehicle?

— How should the acquisition vehicle be financed?

Taxation is a major factor to consider when selecting the structure of the transaction. Company law and accounting issues are also highly significant. These areas are outside the scope of this report, but some of the key points that arise when planning the steps in a transaction are summarized later in this report.

Recent developments

The income tax framework in Greece underwent a major reform in 2014 aiming to simplify its previous formalistic and outdated tax regime. Among others, the new income tax provisions introduced new general anti-avoidance provisions, controlled foreign company rules, thin capitalization restrictions, EU dividend participation exemption, country by country reporting obligations, implementation of the EU Merger Directive, etc.

Company law framework for cross-border mergers

Law 3777/2009 applies to mergers of one or more Greek companies with one or more companies established according to the law of another EU member state and having their registered addresses within the EU, or when the company resulting from the cross-border merger has its registered address in Greece. However, this law does not apply to cross-border mergers involving Undertakings for Collective Investment in Transferable Securities (UCITS) (i.e. companies that raise investment of capital from the public for the purpose of spreading investment risk and whose unit parts are redeemable by participants on demand, directly or indirectly through the company's assets).

The following types of companies can benefit from the provisions of this law:

— *societes anonymes* (AE)

— limited liability companies (EPE)

— partnerships limited by shares

— European companies (*societas Europaea* — SE) whose registered addresses are in Greece

— joint stock companies with legal personalities that possess separate assets that cover any of the company's liabilities and are, according to national legislation, subject to warranty conditions, such as those in the EU Directive 68/151/EU regarding the protection of the shareholders' and third parties' interests.

Also permitted are cross-border mergers of companies with different legal forms that fall within the directive's scope (e.g. between a Greek AE and a German limited liability company — GMBH).

This law applies to mergers by absorption, mergers with the formation of a new company, and absorption by a company that holds all the securities/shares of the absorbed company.

The relevant provisions of the ITC regarding mergers and other restructurings apply to any company that:

— has one of the forms listed in Annex I, Part A of Directive 2009/113 (regarding Greek companies, these provisions apply to SAs, EPE companies and private capital companies (IKE))

— is, according to the tax laws of a member state, considered to be resident in that member state for tax purposes

— is not considered under the terms of a tax treaty concluded with a third country to be resident for tax purposes outside the European Community

— is subject to one of the taxes listed in Annex I, Part B, without the possibility of an option or of being exempt, or becomes subject to any other tax that replace such taxes in the future (i.e. Greek companies must be subject to corporate income tax).

These ITC provisions apply to mergers by absorption of one company by another, mergers by way of the establishment of a new company, demergers of companies by way of absorption in existing or the establishment of a new company, partial demergers, contribution of a permanent establishment (PE) to another EU member state, contributions of assets, and exchanges of shares concerning companies in different EU member states.

Transfer pricing obligations

Intragroup transactions should follow the arm's length principle. See 'Transfer pricing' later in this report.

Thin capitalization

Under the ITC, interest expenses are deductible to the extent that the surplus of interest expense compared to interest income does not exceed 30 percent of earnings before interest, taxes, depreciation and amortization (EBITDA). Excess interest that is not deductible in 1 year may be carried forward indefinitely. This provision applies as of 1 January 2017.

The above restriction does not apply and interest is fully deductible where the net amount of interest expense reported in the entity's accounting books does not exceed 3 million euros (EUR) per year as from 1 January 2016.

These thin capitalization rules do not apply to financial institutions.

See the section on deductibility of interest later in this report.

Asset purchase or share purchase

A foreign company may acquire a Greek company either by purchasing the majority or all of its shares (parts in the case of limited liability companies) or by purchasing the company's business assets and liabilities. These two methods for cross-border acquisition have different tax consequences.

Whether a transfer of assets constitutes a transfer of individual assets or a transfer of a business for tax purposes is a question of fact. One needs to consider not only the related legal document but also the facts surrounding the business activity to be transferred. Certain criteria may be used to reach a conclusion, such as:

— whether the transferred segment can be fully and independently operational after the transfer

— whether the specific segment constitutes an independent segment from a functional and management viewpoint

— whether such independence is supported by separate accounting

— whether the transferred activity can be carried out by the buyer

— whether the transferee continues the activity of the transferor

— whether the transferor ceases the business activity of the transferred business.

An acquisition of assets by an EU-based, non-Greek buyer may be eligible for exemption from taxation of capital gains realized by the seller, provided the acquisition is subject to the provisions of Law 2578/1998, as amended by Law 3517/2006, which incorporated in Greek tax legislation the provisions of EU Directive 90/434 as amended by Directive 2005/19 (the EU Merger Directive) or the new provisions of ITC, which incorporated in Greek tax legislation the provisions of EU Merger Directive 2009/113.

Purchase of assets

The purchase of assets offers the buyer the option to buy only those assets that are useful to its business activity. Where the Greek seller realizes a gain from the sale of assets, the gain is taxable to the Greek company as part of its ordinary business income at the normal corporate tax rate. The taxable gain is the difference between the sale price and the net book value of the asset. When real estate is transferred, the purchasing company must pay real estate transfer tax at a rate of 3 percent (plus a local authority surcharge of 3 percent of the real estate transfer tax), subject to the comments in the section on transfer taxes later in this report.

Purchase price

The purchase price for the sale of individual assets is considered to be the price stipulated in the sale agreement (provided the nature of the transactions is not challenged; not deemed to be a transfer of business). The agreed transfer value of assets should be at arm's length. For real estate property, 'capital gain' is defined as the difference between the acquisition and sale price, adjusted for inflation. The acquisition price is considered to be the value indicated in the transfer agreement or that was paid. Where no value is indicated, the acquisition price is the value on which the real estate transfer tax was determined at the time of acquisition. Where the value cannot be determined, it is zero. The sale price is always the price indicated on the transfer agreement at the time of transfer.

Where the assets include shares, the ITC does not provide for a statutory method of calculating the deemed minimum value of unlisted shares. Instead, the sale price for tax purposes (where the seller is an individual) is the amount of the net equity of the company whose shares are being transferred or the actual sale price, whichever is higher.

Such capital gains are considered business income, which is taxable at the applicable tax rate and thus no withholding tax (WHT) applies.

Goodwill

Any capital gain arising for the seller of individual assets is added to the taxable basis of the year in which the sale took place and subject to taxation at the applicable corporate income tax rate.

Any capital gain arising for the seller from the sale of a business (i.e. not individual assets) is added to the taxable basis of the year in which the sale took place and subject to taxation at the applicable corporate income tax rate.

Depreciation

The ITC states that both the owner of fixed assets and the lessee under a financial lease can depreciate the assets where certain requirements are met. Depreciation rates range from 4 percent for buildings to 10 percent for other fixed assets. The depreciation rate of intangible assets and royalties is 10 percent, except where the economic life of the right as contractually determined in the initial agreement is other than 10 years. Moreover, the depreciation of a fixed asset begins in the month following the month in which the asset is used or put into use by the taxable person.

Tax attributes

Where the transfer qualifies as a transfer/contribution of business in exchange of shares issued by the entity receiving the business and the relevant conditions of the ITC are met, accumulated tax losses (related to the business) of the company whose business is being transferred can be transferred to the receiving company as part of the transferred assets.

Value added tax

The transfer of individual assets (where it is not a transfer of a business) is subject to Greek valued added tax (VAT) at the rate of 24 percent. No VAT applies in the case of a transfer of assets that qualifies as a transfer of a business.

Greek VAT law provides that VAT incurred on the acquisition of capital/investment goods, as defined by the law (including the construction of buildings), can be fully offset in the month of acquisition, provided the company holds the asset for 5 years (beginning from the year in which the good was first used) and the company engages in activities subject to VAT. Where the amount of respective input VAT cannot be fully offset against the company's output VAT in the month of the asset's acquisition, it is refunded by the Greek tax authorities according to a procedure specified by the Ministry of Finance.

Where an asset is disposed of before the end of the 5-year period to an activity not subject to VAT or ceases to be used by the company, any VAT balance corresponding to the remaining years of the 5-year period must be remitted to the Greek tax authorities when filing of a monthly VAT return by the last day of the fourth month following the year of the disposal. Alternatively, where an asset is sold before the end of the 5-year period and the transaction is subject to VAT, no VAT settlement obligation arises for the remaining years. Where this is not the case (i.e. no VAT is charged on the sale invoice), any balance due must be settled on a monthly VAT return by the fourth month following the year in which the sale was effected.

Where an asset is transferred as part of a business segment, any VAT obligations remaining under the 5-year settlement procedure pass to the buyer of the business segment.

Transfer taxes

Where the transfer of assets qualifies as a transfer of a business, 2.4 percent stamp duty is imposed on the higher of the net asset value of the business and the selling price (VAT does not apply). The cost of stamp duty may be borne either by the seller or the buyer depending on the agreement between the contracting parties. In the absence of such an agreement, the stamp duty is borne by the buyer.

Real estate transfer tax is levied on the acquisition value of real estate. The tax is computed on the contract price or the objective value, whichever is higher. The objective value system covers real estate situated in almost every part of Greece and was adopted to reduce disputes between the tax authorities and the taxpayer on the taxable value of real estate. Where there is no objective value, the value is determined by the tax authorities. The real estate transfer

tax rate is 3 percent. A local authority surcharge, equal to 3 percent of the transfer tax, is also levied. Mergers of real estate companies are exempt from the real estate transfer tax, provided the absorbing real estate company possesses all the shares of the absorbed company.

According to Article 1 of Law 3427/05 effective from 1 January 2006, VAT is imposed on the transfer of new buildings (construction licenses issued or revised after 1 January 2006) at the rate of 23 percent, provided that they are used for the first time. Following this first transfer, every subsequent transfer is subject to real estate transfer tax. Transfers of old buildings (construction license issued up to 31 December 2005), as well as land and new buildings to be used as the buyer's primary residence, are subject to real estate transfer tax and not VAT.

Purchase of shares

As of 1 January 2014, the gain from the sale of listed and non-listed shares of Greek corporations is considered business income for companies (taxed at the applicable corporate tax rate). For individuals, a 15 percent capital gains tax applies (unless the seller is a resident of a country that has signed a relevant tax treaty with Greece), which is a final tax.

The ITC does not provide a statutory method of calculating the deemed minimum value of unlisted shares. Instead, the sale price for tax purposes is determined (for individual sellers) by reference to the net equity of the company whose shares are being transferred or the actual sale price, whichever is higher.

Moreover, the sale of shares listed on the Athens Stock Exchange is also subject to 0.2 percent transfer duty, which is borne by the seller.

Losses arising from the transfer of shares by individuals may be offset against future profits derived from the same source for up to 5 years.

Tax indemnities and warranties

In a restructuring by means of a share acquisition, the buyer assumes the target company's liabilities. The sale of shares agreement commonly includes special warranty clauses, by which the seller guarantees (usually up to a certain amount) any liabilities or taxes that may arise after the acquisition relating to years before the acquisition.

It is also customary for the buyer to initiate a due diligence exercise, including a review of the target company's tax affairs, before the transaction concludes.

Tax losses

Tax losses arising from business activities may be carried forward and offset against taxable income in the 5 years following the accounting year in which they were incurred. Losses cannot be carried back. Greek companies with business interests (branches) abroad may offset losses incurred by their foreign interests solely from profits arising from the same business interest abroad and not from profits arising from their business activity in Greece. By exception, the set-off of losses arising in other EU or European Economic Area (EEA) member states through a branch is permitted against profits from business activities within Greece provided the losses are derived from the branch's termination and the profits are not exempt under a Greek tax treaty.

Where the ownership or voting rights of an enterprise are changed at a percentage exceeding 33 percent during a tax year, the above carry forward of the losses is not permitted unless the taxpayer can prove that the change in ownership occurred for commercial or business purposes and not for tax evasion/avoidance purposes.

The concept of group tax relief does not exist in Greece. Companies cannot transfer losses to other companies in the same group.

Crystallization of tax charges

The buyer should be aware of all liabilities transferred to the target company that may be subject to taxation on their distribution by the target company, such as special reserve accounts that were created to capture the benefits of incentive laws on previous restructurings/acquisitions. The buyer also should be aware that the tax liability for a particular financial year is crystallized at the time of its tax audit. Therefore, it is common practice to arrange for a tax audit immediately following the change of ownership.

Pre-sale dividend

The pre-sale dividend may be taken through an increase in the consideration or through the payment of an interim dividend prior to the sale. Dividends distributed by Greek corporations to Greek or foreign individuals or legal entities, as well as dividends distributed by foreign entities to individuals who are residents of Greece, are subject to 15 percent WHT, which is the final tax liability of individuals who are the beneficiaries of that income. No tax is withheld where the beneficiary of dividends is a parent company established in another EU country, provided the latter is eligible for exemption on the basis of the provisions of the EU Parent-Subsidiary Directive.

The decision on whether or not to distribute a pre-sale dividend should be based on comparing the tax liability that would arise from the expected share transfer profit with and without the dividend distribution.

Stamp duty

No stamp duty applies to the sale of shares.

Choice of acquisition vehicle

Several vehicles are available for acquiring either assets or shares in Greece. The choice depends on the transfer tax and exemptions, the cost of maintaining the acquisition vehicle, corporate income tax issues, and potential exit planning

issues. The funding structure is also important because interest on debt is normally deductible for income tax purposes.

Local holding company

Each type of legal entity has certain legal characteristics, as well as specific taxation pros and cons, so the choice depends on tax, economic and legal factors. Greek entities are generally classified as follows.

Corporation (*Societe Anonyme/Anonimi Etaireia*)

— Company law governs the formation.

— Qualifying quorum and majority needed for certain decisions.

— For corporate law purposes, shareholders are responsible for the liabilities of the company up to the amount contributed to the company's share capital. Shareholders can be held liable for tax and social security law liabilities in certain conditions.

— Earnings are taxed at corporate level at 29 percent.

— 15 percent WHT applies on dividends.

Limited liability company (*Etaireia Periorismenis Efthinis*)

— Company law governs the formation.

— Majority of both number of partners and capital needed for decisions.

— For corporate law purposes, partners are responsible for the liabilities of the company up to the amount contributed to the company's share capital. Partners can be held liable for tax and social security law liabilities in certain conditions.

— Earnings are taxed at the corporate level at the same rate as corporations.

— 15 percent WHT applies on distribution of profits.

Private capital company (*IKE*)

— Company law governs the formation.

— Majority of partnership units needed for decisions.

— For corporate law purposes, partners are responsible for the liabilities of the company up to the value of their contributions to the company. Partners can be held liable for tax and social security law liabilities in certain conditions.

— Earnings are taxed at the corporate level at the same rate as corporations.

— 15 percent WHT applies on distribution of profits.

General/limited partnership (*Omorythmi/Eterorythmi Etaireia*)

— Commercial law governs the formation.

— General partners are responsible for the liabilities of the partnership with their personal assets; liability of the limited partners in limited partnerships is confined to the capital they have contributed.

— Profits are taxed at 29 percent.

European company (SE)

— EU legislation (Regulation 2157/2001 and EU Directive 2001/86) and local legislation (Law 3412/2005, Presidential Decree 91/2006 and company law) govern the formation and management.

— Taxed as a Greek corporation.

A Greek holding company does not provide any particular benefit for the buyer of shares in a Greek entity because no deduction is available for the debt costs incurred for the acquisition of shares or partnership units. However, any tax losses of the acquired entity can be used by the Greek holding entity where the two companies are eventually merged by virtue of the ITC's provisions for mergers and restructurings.

Other disadvantages are as follows:

— Profits distributed by Greek AE entities to Greek-resident parent entities are subject to 15 percent dividend WHT unless the receiving entity has a participation percentage of at least 10 percent in the distributing entity and the participation is held for at least 24 months.

— Capital concentration tax of 1 percent applies on the nominal share capital of the holding entity (except in the case of initial formation/establishment of the entity).

— Any interest for funding the acquisition cannot be used for income tax purposes in case of a holding company because the company likely has revenues derived from shareholding (dividends) that are exempt from income tax.

Foreign parent company

A foreign entity may decide to acquire directly the shares or partnership units in a Greek entity to benefit from a deduction in its jurisdiction of debt costs incurred for the acquisition of the participation in Greece. No tax registration in Greece is required merely for purchasing shares. On sales of shares by non-Greek residents, registration is required, regardless of whether the sale is exempt from taxation in Greece under a tax treaty. Tax registration of the foreign entity is required for the purchase of partnership units.

Under most Greek tax treaties, capital gains from the sale of shares and/or partnership units are exempt from Greek income tax.

Since no tax grouping applies in Greece, a foreign entity may decide to acquire an entity directly to benefit from potential tax group relief provided in its country of residence and covering foreign subsidiaries.

No dividend WHT is imposed on profits distributed by Greek AE entities to EU-based affiliates qualifying for the application of the EU Parent-Subsidiary Directive.

Non-resident intermediate holding company

Where the foreign parent entity is resident in a country outside the EU and there is no tax treaty to reduce or eliminate the applicable WHT, an EU intermediate holding company could be used to benefit from the provisions of Greek income tax legislation. Under these provisions, an EU parent entity that holds participation in a Greek entity for 2 consecutive years of at least 10 percent is exempt from the dividend WHT on any profits distributed by the Greek subsidiary.

Further, an intermediary holding company may be used where the tax treatment of capital gains on the disposal of shares is more favorable in a jurisdiction other than the parent entity's jurisdiction.

Greek branch

Acquisitions of assets in Greece may be effected through a Greek branch already established. This has the same result as an acquisition of the Greek assets directly from a foreign entity; that is, the foreign entity ends up with a PE in Greece, unless the assets acquired do not constitute a business or are not used for business purposes in Greece. The acquisition of a participation in a Greek company through a Greek branch has the same tax consequences as establishing a Greek holding company.

The tax treatment of a Greek branch is similar to that of a Greek corporation or limited liability company. However, profits credited or distributed to the head office abroad are exempt from WHT. It may be possible, depending on the legislation in the jurisdiction concerned, to use losses incurred by a Greek branch against profits earned by the head office. The comments in this report about the sale of a business as a going concern apply to the sale of the Greek branch.

An exemption from capital concentration tax is allowed for capital allocated to the Greek branch by an EU-based head office.

Law 2166/1993 recognizes the following ways to effect cross-border mergers that involve branches that have been established in Greece by foreign companies:

— merger by absorption of a branch that has been established in Greece by a foreign company into a Greek corporation or limited liability company

— merger of branches of foreign companies that are established in Greece through the establishment of a Greek corporation or limited liability company.

Further, Greek jurisprudence appears to accept that the tax incentives of Law 2166/1993 should apply to transactions between companies in another member state that have consequences for their establishment in Greece.

These mergers are exempt from taxation where the enterprises involved:

— maintain double-entry accounting books

— have prepared at least one balance sheet for a 12-month period

— are considered as operating

— and comply with certain capital requirements.

The merging enterprises are required to prepare a merger balance sheet on a fixed date, which is audited by the tax authorities, certified auditors or a committee appointed by the Ministry of Development. The merger is accomplished by consolidating the assets and liabilities as they appear in the financial statements. The result is that no taxable capital gains arise.

The following tax advantages arise from the application of Law 2166/1993:

— no revaluation gain arises, so no capital gains tax is due

— exemption from stamp duty

— exemption from real estate property transfer tax

— transfer of tax-free reserves and any potential tax benefits to the receiving company.

Cross-border mergers that involve branches established in Greece by foreign companies may enjoy the tax advantages provided by Law 2578/1998 as amended by Law 3517/2006 that implemented EU Directive 90/434 as amended by EU Directive 2005/19 (Merger Directive), provided the directive's conditions are met.

In addition, according to the ITC provisions that regulate the cross-border contribution of assets of one company (contributing company) in exchange for shares of another company (receiving company), a transformation of a Greek branch into a newly established legal entity (which is a subsidiary of the branch's head office) is considered a contribution of assets for purposes of those provisions. The main tax benefits of these provisions are as follows:

— Capital gains arising from such contribution are not subject to tax.

— Depreciation may be taken by the receiving company on the assets of the contributing company using the same asset values and the same method used by the contributing company.

— Reserves and provisions of the contributing company may be transferred to the receiving company without prejudice to existing tax exemptions and conditions.

— The receiving company assumes rights and obligations in connection with reserves and provisions.

In order for the provisions to apply, the receiving company must retain the shares for at least 3 years unless it can prove that the subsequent transfer was not carried out for tax avoidance/evasion purposes.

Joint venture

In commercial practice in Greece, a joint venture (*koinopraxia*) involves the cooperation of individuals or legal entities for the purpose of pursuing and carrying out a specific project. Where the joint venture carries out business/commercial activities, it acquires a separate legal personality by registering with the General Commercial Registry for companies. The joint venture is also recognized as an entity for tax purposes, provided certain conditions are met. Profits realized by the joint venture are subject to 29 percent tax. Each participant is jointly and severally liable for the joint venture's tax liabilities.

However, there are no particular tax benefits in participating in a Greek entity with another investor.

Choice of acquisition funding

After deciding to use a Greek entity for the acquisition of assets in Greece or the acquisition of shares or partnership units in Greek entities, the choice between debt and equity financing depends on both tax and corporate law implications. The main issues to be considered are summarized below.

Debt

Debt received from a Greek entity may take the form of a bank loan, a corporate loan or a bond. Special considerations arise from corporate law provisions in respect of corporate and bond loans:

— A corporation is not allowed to grant loans to members of its board of directors, persons exercising control over the corporation or their spouses or relatives up to third degree, or to companies controlled by such persons.

— Loans to third parties for the acquisition of shares of the corporation may be permissible under certain conditions.

— Bond loans should be issued with at least two bonds and two bondholders, and care must be taken to ensure they are not considered to be mere corporate loans.

Stamp duty of 2.4 percent applies on the capital and interest of corporate loans unless they are concluded and executed abroad. In addition, banking loans are subject to the special levy of Law 128/1975, calculated at 0.6 percent of the monthly average balance of the loan. Bond loans are exempt from stamp duty and the Law 128/1975 levy.

Deductibility of interest

Generally, the ITC provides for the deductibility of all actual and evidenced business expenses (including interest payments) that are incurred for the benefit of the business.

By exception, interest is not deductible on loans entered into with third parties, except for bank and bond loans, to the extent the interest exceeds that which would have arisen based on the rate applicable to revolving lines of credit granted to non-financial companies. This rate is the rate reported in the latest Statistical Bulletin of the Central Bank of Greece published just prior to the date that the loan was concluded.

Under the ITC, interest expenses are deductible to the extent that the surplus of interest expense compared to interest income does not exceed 30 percent of EBITDA. Surplus interest that is not deductible may be carried forward indefinitely.

The above restriction does not apply and interest is fully deductible where the net amount of interest expense reported in the entity's accounting books does not exceed EUR3 million per year.

Withholding tax on debt and methods to reduce or eliminate it

WHT at the rate of 15 percent is imposed on interest payments on corporate loans concluded with a Greek tax-resident entity. No WHT is imposed on interest payments made on banking loans granted by Greek banks.

In principle, interest payments to non-Greek tax residents are subject to 15 percent WHT unless the beneficiary qualifies for the application of the EU Interest Royalty Directive (under which WHT is zero as of 1 July 2013) or a tax treaty provides for reduced or zero WHT.

A WHT at a rate of 15 percent is imposed on bond interest paid to Greek and foreign individuals/legal entities-bondholders. Exceptions may apply for non-resident entities with no PE in Greece as well as for non-resident individuals.

With regard to cross-border loan financing, where the interest paid by a subsidiary in Greece to a parent company in a country with which Greece has a tax treaty exceeds the arm's length interest, the advantageous tax treatment (mainly lower WHT rates) is restricted to the amount of arm's length interest.

Checklist for debt funding

— The use of bank debt may avoid transfer pricing problems. However, where an affiliate acts as a guarantor for such debt, transfer pricing issues may arise.

— The use of bond loans under the provisions of Law 3156/2003 is exempt from stamp duty and the Law 128/1975 levy.

— A reduction of or exemption from WHT on interest could be available for foreign tax-residents under either the EU Interest Royalty Directive or a relevant tax treaty.

— Deductibility of interest should be viewed in the light of the general deductibility requirements in Greek tax legislation, the Greek holding entity's lack of taxable income to offset such interest, and the absence of tax-grouping provisions in Greek tax legislation. Debt pushdown options should be considered in this context.

Equity

A buyer may use equity to fund the acquisition of either shares or assets in Greece. This can be effected by issuing shares, in which case the seller contributes shares in or assets of a Greek entity owned by the buyer. Alternatively, the transaction can be effected under the provisions of Law 2578/1998 (exchange of shares) or the ITC. Law 2578/1998, as amended by law 3517/2006, implemented the EU Mergers Tax Directive (Directive 90/434 and Directive 2005/19 amending Directive 90/434) into Greek law and applies to mergers, demergers, partial demergers (transfers of one or more branches of activity), contributions of assets and exchanges of shares between companies established in different EU member states. This law also applies to the transfer of the registered office of an SE or SCE from Greece to another EU member state. The conversion of a branch into a subsidiary falls within the meaning of contribution of a segment.

Accordingly, any gains that arise from a merger, demerger, partial demerger or contribution of assets by a Greek AE, EPE or IKE company to a company resident in another EU member state are not subject to Greek income tax.

The same exemption applies to the contribution of a PE (branch) in Greece by a foreign company resident in an EU member state to a company resident in another EU member state, including Greece. The exemption does not apply to a Greek company that contributes its PE (branch) situated in another member state to a company resident in another EU member state. Where the transferred assets of a Greek AE, EPE or IKE company also include a PE (branch) situated in another EU member state, any gains arising from the transfer of the PE are subject to Greek income tax. However, the tax that would have been imposed in the other EU member state where the provisions of this law were not applicable will be offset.

Special provisions apply to foreign companies that the Greek tax authorities view as fiscally transparent.

The provisions of paragraph 1 of article 3 and paragraphs 2 and 3 of Article 6 of L.D. 1297/1972 (i.e. exemption of the merger agreement and any other action needed for the implementation of the merger from any tax, stamp duty or duty in favor of any other third party), as in force, apply to the operations provided for in Law 2578/1998.

As mentioned, the ITC regulates mergers, demergers contributions of assets and exchanges of shares concerning companies in different EU member states. According to these provisions and provided certain conditions are met, capital gains arising from such transactions are not subject to tax.

In addition, the buyer may want to use either a Greek holding entity as an acquisition vehicle, which is funded though capital injections, or may acquire an interest in a Greek entity by participating in a share capital increase (placing) in which existing shareholders waive their rights to participate.

Capital concentration tax at a rate of 1 percent is imposed on the value of the share capital increase. Where capital of Greek AE entities is increased, a 0.1 percent competition committee duty also applies.

A 15 percent WHT on dividends applies on profits distributed from Greek AE entities, except where an exemption applies to holding companies based on the EU directive and the ITC.

The use of equity may be deemed more appropriate in certain circumstances, such as:

— where no tax deduction could be obtained for interest charges on debt

— where there is the intention to inject capital following the acquisition, in which case it may be appropriate to acquire such participation through a share capital increase in which only the buyer participates (for Greek AE entities, participation of a third party in a share capital increase has no share transfer tax implications)

— where thin capitalization restrictions apply to the deductibility of interest

— where the net asset ratio (nominal share capital divided by net equity) falls under 50 percent, in which case the board of directors and general assembly of a Greek AE entity should take action to improve the ratio.

Where the net asset ratio falls below 10 percent, the company may be dissolved by a court decision under certain conditions. In such cases, it may be necessary to proceed with the capital increase to improve the ratio and avoid an interest expense, which may lead to losses that worsen the net asset ratio even further.

Hybrids

There are no specific tax provisions for the use of hybrid instruments in Greece. The legal and tax treatment of each hybrid instrument should be examined on a case-by-case basis, and special legal and tax advice should be sought to determine its tax treatment in Greece.

Discounted securities

Discounted securities sold by a Greek entity to a third party result in the following, depending on the nature of the securities:

— In principle, losses realized on the sale of Greek state bonds are considered as tax-deductible and thus reduce the revenues earned during the year of sale. However,

losses realized from Greek corporate bonds issued under L. 3156/2003 (as well as similar bonds issued within the EU and EEA/EFTA) are not tax-deductible since the corresponding gains are tax-exempt.

— In principle, losses realized on the sale of foreign securities (that are not held through a foreign permanent establishment/branch) are tax-deductible.

Deferred settlement

Any part of the consideration that is deferred gives rise to transaction tax, capital gains tax, indirect tax and income tax implications on its crystallization. Where the crystallization is effected over more than 1 year, the related tax implications will arise in each year the deferred consideration is paid, and relevant tax returns must be filed with the tax authorities.

Other considerations

Concerns of the seller

As mentioned earlier, where the business of a company (corporation, limited liability company or private capital company) or partnership is transferred as a whole, the individual seller is obliged to pay capital gains tax at the rate of 15 percent. Such tax extinguishes the tax liability of the individual seller. Where the seller is a legal entity, no capital gains tax applies, but such gains are taxed at the corporate tax rate of 29 percent.

Sales of listed and non-listed shares of Greek corporations by individuals are subject to a 15 percent capital gains tax, which is borne by the seller and extinguishes the tax liability. However, where such sale is considered a business activity, it is taxed at the personal tax rates. Where the individual seller resides in a treaty country and files the relevant documents, such tax does not apply. For a resident corporate seller, the capital gain is taxed as regular business income. Non-resident legal entities with no PE in Greece should not incur any tax on gains on sales. As mentioned above, the sale of shares that are listed on the Athens Stock Exchange is subject to 0.2 percent transfer duty borne by the seller.

Company law and accounting

Codified Law 2190/1920, as amended, regulates the formation, management, operation and dissolution of Greek corporations (AE). Law 3190/1955 regulates the aforementioned for limited liability companies (EPE), whereas Law 4072/2012 regulates Greek IKE companies. These laws include provisions on mergers and acquisitions between Greek AE, EPE and IKE companies.

As noted, Greek legislation recently implemented EU Directive 2005/56 with law 3777/2009, introducing the legal framework required from a corporate law viewpoint for cross-border mergers between EU companies. Law 3412/2005 regulates the establishment and operation of the SE in Greece and provides for the cross-border merger of a Greek company with another EU company to form an SE.

As mentioned, the ITC also regulates cross-border business restructurings.

There are no specific provisions in Greek company law on mergers between partnerships, but Greek tax law recognizes their existence.

The accounting treatment of transformations (mergers and asset acquisitions) mainly depends on the method used and the legal framework under which the transformation takes place.

Group relief/consolidation

For Greek income tax and VAT purposes, no tax grouping provisions exist, so no tax group relief is available.

Transfer pricing

General

As mentioned, intragroup transactions should follow the arm's length principle. Where intragroup transactions are carried out cross-border or domestically under economic or commercial conditions that differ from those that would apply between non-affiliated persons or between affiliated persons and third parties, any profits that would have been derived by the domestic company without those conditions, but were not derived due to the different conditions, are included in the company's profits only to the extent that they do not reduce the amount of tax payable. The definition of 'affiliated person' is extensive.

The law explicitly refers to the transfer pricing guidelines of the Organisation for Economic Co-operation and Development (OECD) regarding the interpretation and application of its provisions on intercompany transactions. The documentation requirements for intercompany transactions are included in a separate law (i.e. the new Tax Procedure Code).

Documentation requirements

The transfer pricing documentation file is accompanied by a summary information sheet, which is submitted electronically to the General Secretariat of Information Systems of the Ministry of Finance within 6 months from the end of the accounting period.

The documentation obligation encompasses all intercompany transactions and not only cross-border intercompany transactions.

To support the arm's length nature of transactions in the documentation file, the appropriate transfer pricing method needs to be verified and one or more benchmarking studies may need to be carried out.

A company is exempt from the documentation obligation where its intercompany transactions (or transfers of functions) do not exceed:

— EUR100,000 in total per tax year where the company's gross revenues per tax year does not exceed the amount of EUR5 million, or

— EUR200,000 in total where the gross revenues exceed EUR5 million per tax year.

Advance pricing agreements

The new Tax Procedure Code introduced the option for companies to obtain an advance pricing agreement (APA) covering the transfer pricing methodology of specific future intragroup transactions. The APA duration cannot exceed 4 years, and the APA cannot have retroactive effect. The tax authorities have the right to revoke or cancel an APA in certain cases, and the tax authorities/taxpayer must amend the APA in certain conditions. Transactions for which an APA has been obtained are excluded from the transfer pricing documentation requirements. Where an APA exists, the tax audit is limited to verifying the company's adherence to the APA's terms and the validity of critical assumptions.

Penalties

The penalties for late-filing or non-filing of the summary information sheet or transfer pricing documentation file are as follows:

— A penalty of EUR500 to EUR 2,000, calculated as 0.1 percent on the intercompany transactions for which the documentation is required, applies for late, inaccurate or incomplete submissions of the summary information sheet. For late submission of an amended summary information sheet, the penalty applies only if the difference in the amount of the transactions exceeds EUR200,000. Where the summary is inaccurate, the penalty applies only if the amount of inaccuracy is higher than 10 percent of the total intercompany transactions for which the documentation is required.

— A penalty of EUR2,500 to EUR10,000, calculated as 0.1 percent on the intercompany transactions for which the documentation is required, applies for the non-submission of the summary information sheet.

— A penalty of EUR 5,000 is imposed where the transfer pricing documentation file is submitted to the competent tax authority within 31 to 60 days after its request.

— A penalty of EUR10,000 is imposed where the file is submitted within 61 to 90 days after the request.

— After 90 days, the penalty is EUR20,000. The same penalty applies where the transfer pricing documentation file is not submitted to the tax authorities upon a tax audit following their request.

Dual residency

There are no special provisions for entities considered dual residents in Greece. Unless a relevant tax treaty provides for a procedure to resolve the issue, the Greek tax authorities would tax the dual resident entity's worldwide income in Greece and, subject to certain limitations, provide a tax credit for any foreign tax paid abroad. Issues may be resolved through the mutual agreement procedure as provided in a relevant tax treaty and through the procedure incorporated in Greek legislation.

Foreign investments of a local target company

Any profits realized from foreign investments of a Greek entity are taxable as income from business activities tax. In principle, any loss arising from a foreign investment is deductible to the extent that it is not held through a foreign branch.

Comparison of asset and share purchases

Advantages of asset purchases

— The purchase price (or a portion of it) may be amortized for tax purposes.

— No previous liabilities of the company are inherited.

— Possible to acquire only part of a business.

Disadvantages of asset purchases

— Where the purchased assets form a separate branch of activity or where the transaction is considered a transfer of an enterprise, there may be a need to renegotiate supply, employment and technology agreements and to change stationery, and there may be no protection from previous liabilities.

— A capital gain arises where the transaction qualifies as a business transfer.

— No tax losses are transferred unless the relevant ITC provisions regarding corporate restructurings apply.

— Real estate transfer tax at 3.09 percent is payable by the buyer (if real estate property is transferred) unless the relevant ITC provisions regarding corporate restructurings apply.

— The purchase may be subject to state and local transfer taxes and VAT.

— The asset(s) may not be free of encumbrance surety.

— Where assets are acquired under the provisions of either Law 2166/1993 or Law 2578/1998, the acquisition process may be time-consuming.

Advantages of share purchases

— The company/business remains the same, since only the shareholding changes.

— No need to enter into new supply, employment and technology agreements, among others.

— No transfer tax is payable on the net assets acquired.

Disadvantages of share purchases

— The purchase price is not tax-deductible.

— Capital gains are taxed at the corporate tax rate of 29 percent.

KPMG in Greece

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Hungary

Introduction

This overview of the Hungarian regime for mergers and acquisitions (M&A) and related tax issues only discusses statutory frameworks for acquisitions in Hungary. It does not consider any specific contractual arrangements that may affect such transactions.

The primary legislation governing the form and regulation of companies is ACT V of 2013 on the Civil Code (the Civil Code), effective since 15 March 2014. As a result of the accession of Hungary to the European Union (EU) on 1 May 2004, new forms of business associations have been integrated into the Hungarian company law legislation, such as the European economic interest grouping and the societas Europaea (SE).

Recent developments

In the past few years, the Hungarian parliament approved several tax law changes that might have implications for M&A transactions in Hungary. The key tax law changes are as follows:

— As of 1 January 2017, the statutory corporate income tax (CIT) rate in Hungary is 9 percent (flat rate).

— As of 1 January 2012, the provisions on carry forward losses have changed significantly. According to the new rules, tax losses may only be utilized for up to 50 percent of the tax base (calculated without utilization of carry forward losses), and further restrictions may apply on changes in ownership structure and/or transformations (mergers, demergers). As of 1 January 2015, the rules on tax loss carry forward became even stricter, with a general 5-year time limitation introduced for tax losses arising in 2015 or later. Tax losses generated before the end of 2014 may be utilized by the end of 2025. Further restrictions may apply on the amount of tax loss carry forward in the event of a change in ownership structure and/or transformation (merger, demerger). See 'Purchase of shares' for details.

Asset purchase or share purchase

An acquisition in Hungary usually takes the form of a purchase of shares of a company, as opposed to its business and assets, because capital gains on the sale of shares may be exempt from taxation, while the purchase of assets might be subject to VAT. The advantages and disadvantages of asset and share purchases are compared later in the report.

Purchase of assets

According to Hungarian legislation, a gain from the sale of assets is taxable for the company that sells those assets. The gain becomes part of the general tax base and is subject to 9 percent CIT.

Generally, the sale of assets is also subject to the standard VAT rate, which is currently 27 percent.

In addition, transfers of immovable property, vehicles and rights related to them are subject to transfer tax. The transfer tax base is the market value of the assets transferred. The standard rate of the tax is 4 percent for real estate up to 1 billion Hungarian forint (HUF) and 2 percent on the excess amount. The amount of the tax cannot exceed HUF200 million per plot number.

Thus, the transfer of the real estate and any other asset mentioned earlier may trigger a transfer tax liability payable by the buyer.

Purchase price

The transfer pricing rules apply to sales of assets between related parties. In Hungary, the transfer pricing rules broadly comply with the Organisation for Economic Co-operation and Development (OECD) transfer pricing guidelines. The transfer pricing rules allow the tax authorities to adjust taxable profits where transactions between related parties are not at arm's length prices.

Goodwill

Under changes to the Hungarian Accounting Law announced in 2016, goodwill and badwill can only arise in standalone financial statements if the acquisition is realized through item-by-item recording of assets and liabilities (i.e. asset deal). Goodwill and badwill cannot arise where the entity obtains qualified majority influence through the acquisition

of interest in another company. In line with this treatment, the consideration (purchase price) paid on a purchase of interest is considered as the book value of the participation.

Under a transitional rule, where the book value of goodwill or badwill cannot be presented separately based on these new rules, an amendment should be made to the 2016 opening balance of the related participation. However, the goodwill or badwill should remain on the books where:

— the value of the badwill exceeds the 2016 opening balance of the related participation, and

— the relating participation can no longer be found in the books.

As of 1 January 2016, goodwill is depreciated over 5 to 10 years for accounting purposes if its useful lifetime cannot be estimated. A 10 percent tax depreciation also may be claimed for CIT purposes, if a declaration is made in the respective tax return that the circumstances of both presenting and cancelling the goodwill in the books was in line with its intended purpose (i.e. not abusive). The previous regime did not allow the ordinary depreciation of goodwill for accounting purposes; however, an extraordinary depreciation might have been accounted for on goodwill (e.g. if the book value permanently and significantly exceeded the market value), which qualified as tax-deductible for CIT purposes.

For goodwill or badwill that may remain in the books despite of the 2016 changes, the taxpayer may choose between applying the new rules or continuing with the rules that were in force at the time the goodwill was recorded in the books.

Depreciation

The purchase price of the assets may be depreciated for tax purposes. The Act on Corporate Income and Dividend Tax stipulates the depreciation rates to be used for various assets. The depreciation rates for tax and accounting purposes may differ for certain assets.

Tax attributes

According to the Hungarian legislation, any gain from the sale of assets is taxable for the company that sells them. The gain is part of the general tax base and subject to 9 percent CIT. The transfer pricing rules apply to sales of assets between related parties.

Value added tax

In general, the sale of assets is subject to the standard value added tax (VAT) rate, currently 27 percent. As of 1 January 2013, the transfer of a business unit may be out of scope of VAT if all of the following conditions are met:

— The acquirer acquired the business line with the aim of further operation.

— The acquirer is a Hungarian tax-resident entity (or becomes Hungarian tax-resident as a result of the in-kind contribution).

— The acquirer undertakes an obligation to assume the rights and obligations prescribed under the Act on VAT in connection with the assets acquired (with certain exceptions) at the time of acquisition (e.g. monitoring period for properties).

— The acquirer does not have any legal status that would violate the above obligation (e.g. VAT-exempt activity).

— The activity of the business line is limited to the supply of goods and services giving rise to deduct the VAT.

— Where the acquired assets include real estate, if the seller opted for a VAT-able sale of real estate or the sale of real estate is otherwise VAT-able (e.g. new real estate), the buyer is obliged to opt for VAT-able sale of real estate.

If these conditions are not met, the transfer of a business unit would be regarded as a single service provision based on the current approach of the Ministry for National Economy and the Tax Authority. Thus, the whole purchase price of the business unit would be subject to VAT at a rate of 27 percent.

Transfer taxes

If the assets to be sold include real property, as noted earlier, the buyer is liable to pay real estate transfer tax. As of 1 January 2010, the standard rate of the tax is 4 percent for real estate up to 1 billion Hungarian forint (HUF) and 2 percent on the excess amount. The tax is capped at HUF200 million.

No real estate transfer duty liability arises if the transfer is a result of a preferential transformation or preferential exchange of shares as defined by the CIT law and the acquirer is established (or has its place of effective management) in a state where:

— the effective CIT rate of the acquirer is at least 9 percent

— in the case of zero or negative financial result, the nominal CIT rate of the country is at least 9 percent, and

— the general domestic law of the acquirer's country stipulates at least 9 percent tax on income from the sale of the participation.

Purchase of shares

As an incentive for establishing holding companies in Hungary, domestic or foreign participations could be considered as announced participations, which are reported to the tax authority within 75 days following the acquisition. (The participation limit is abolished as of 1 January 2018, and the reporting deadline was extended from 1 January 2014.) The capital gains on such participations held for at least 1 year are exempt from CIT. An investment cannot be treated as an

announced participation, and thus the special rules cannot be applied, if it is in a controlled foreign company (CFC). The rules for CFCs are discussed later in the report.

As of 1 January 2012, no further reporting is necessary if only the value of the reported shareholdings increases but the percentage of these shareholdings remains unchanged.

In a share acquisition, the buyer may benefit from existing supply or technology contracts of the target company and also from all permits, licenses and authorizations of the target company, unless the agreement between the parties stipulates otherwise.

Capital gains derived from the sale of shares in a Hungarian real estate company (REC) are generally taxable. Hungarian regulations define a 'REC' as a company that owns among its assets at least 75 percent Hungarian-located real estate. As of 1 January 2014, the book value is considered for this purpose instead of the market value. The capital gains on the sale of REC shares are taxable if the quota/shareholders of the REC or a related party are resident in a country that does not have a tax treaty with Hungary or has a treaty allowing the taxation of capital gains in Hungary. Of course, any applicable double tax treaty might override this rule.

Tax indemnities and warranties

In a share acquisition, the buyer is taking over the target company together with all related liabilities, including tax liabilities. It is common practice for the buyer to conduct a due diligence investigation of the target company to identify potential risks. In addition, the buyer may require indemnities and warranties from the seller.

Tax losses

The tax losses generated by the target company transfer with the target company, so the target company keeps its tax losses after the sale of shares. However, due to several tax law changes, the potential utilization of such losses is subject to strict criteria.

As of 1 January 2012, tax losses may only be utilized up to 50 percent of the tax base (calculated without the utilization of tax losses). This rule should also apply to tax losses previously carried forward. As of 1 January 2015, a general 5-year time limitation applies for tax losses arising in 2015 or later. Tax losses generated until the end of 2014 may be utilized by the end of 2025.

On a corporate restructuring (e.g. merger), previous losses can only be utilized by the legal successor, where the new owner (or its related-party company) acquiring direct or indirect majority influence in the successor had the same influence in the legal predecessor before the transformation (on the day preceding the effective date of the merger); and where the successor realizes revenue from at least one activity pursued by the legal predecessor for the 2 tax years following the merger. The activity test does not apply on liquidation or where the legal predecessor's original activity was a holding activity.

Change in ownership restrictions may apply to the utilization of tax losses in the case of acquisitions. If the new owner acquiring direct or indirect majority influence was not related to the taxpayer continuously in the 2 tax years before the acquisition, available tax losses can only be utilized where the acquired company carries out its activity for at least 2 years after the acquisition and it realizes revenue from this activity in both tax years; or where the company is listed on a stock exchange. The activity criteria requires the target company to continue and realize income from its activity without significant changes (e.g. holding activity instead of production activity is not allowed).

As of 1 January 2015, a further limitation was introduced on the utilization of available tax losses after group restructurings (e.g. mergers) and acquisitions. Under this limitation, tax losses may only be utilized in the proportion of the annual net revenues generated from the continued activities to the average revenue generated from such activities in the preceding 3 tax years.

Transfer taxes

The purchase of shares in a REC may be subject to real estate transfer tax where the buyer holds 75 percent or more of the shares.

Real estate transfer tax is payable by the buyer of the shares. The base of the transfer tax is the market value of the real estate transferred, prorated to the ownership ratio. As of 1 January 2010, the standard rate of the tax is 4 percent for real estate up to 1 billion Hungarian forint (HUF) and 2 percent on the excess amount. The tax is capped at HUF200 million per plot number. Therefore, if a real estate property is registered under several different plot numbers at the Land Registry, it qualifies as several separate real estate properties for transfer tax purposes. Starting in 2014, only share deals in RECs are subject to transfer tax (those having at least 75 percent real estate asset ratio for accounting purposes) and the activity criteria (i.e. application to only companies carrying on activity in real estate) no longer applies.

Tax clearances

If an acquisition of shares is deemed a preferential exchange of shares, the gain on the shares may be deferred if all criteria set out in the Act on Corporate Income and Dividend Tax are met. In a preferential exchange of shares, a company (the acquiring company) acquires an interest in the issued capital of another company (the acquired company) in exchange for issuing to the acquired company's member(s) or shareholder(s) — in exchange for their securities — securities representing the issued capital of the former company. If applicable, the acquiring company makes a cash payment not

exceeding 10 percent of the nominal value or, in the absence of a nominal value, of the accounting par value of the securities issued in exchange, provided that the acquiring company obtains a majority of the voting rights in the acquired company or increases its holding if it already held a majority of the voting rights before the transaction.

As of 1 January 2012, tax on the preferential exchange of shares can only be deferred if there is a real economic or commercial rationale for such transactions.

Choice of acquisition vehicle

A foreign buyer has various options as its acquisition vehicle for the purchase of assets and shares, each of which might have different tax consequences.

Local holding company

The use of a Hungarian holding company might be favorable where the Hungarian company used a loan to finance the acquisition and could deduct interest paid on the debt from its CIT base.

A Hungarian holding company could also be used as a special-purpose vehicle in the case of a privileged transformation.

The Hungarian Tax Office recently started to challenge schemes involving the push-down of debt into operations. Pre-clearance in the form of a binding ruling is strongly recommended.

Foreign parent company

The use of a foreign parent company generally would not have Hungarian CIT implications at the level of the foreign parent company (unless an applicable tax treaty allows for taxation of the capital gains of RECs).

Hungary does not levy withholding tax (WHT) on dividends paid by a Hungarian company.

Hungarian WHT on interest, royalties and certain service fees was abolished as of 1 January 2011.

Non-resident intermediate holding company

An intermediate holding company might be advantageous where the intermediate holding company is resident in a country that has a more favorable tax treaty with Hungary such that the tax on capital gains or dividends might be deferred or eliminated. Hungary has an extensive treaty network. The table at the end of the report shows the WHT rates agreed in the tax treaties concluded with Hungary.

Local branch

In most cases, non-residents who do not wish to establish a Hungarian-registered company can conduct business in Hungary through branches registered with the Hungarian Court of Registration. Hungarian branches are treated similarly to any other CIT payer. Accordingly, profit transfers from the branch to the headquarters are considered as dividends, although they are not liable to WHT.

A Hungarian branch is subject to Hungarian CIT at 9 percent. The tax base of a branch is calculated based on the accounting profit of the branch, modified by the additions and deductions set out in the Act on Corporate Income and Dividend Tax.

The pre-tax profit of the branch should also be:

— decreased by the indirect head office costs (up to a maximum prorated based on the ratio between the turnover of the branch and the turnover of the foreign entity)

— increased by 5 percent of the income not attributed to the branch but earned through the branch

— increased by operating costs and expenses and overhead of the branch charged to the pre-tax profit or loss.

Relevant tax treaties may override these rules. As of 25 June 2015, amendments to the Hungarian CIT legislation require application of a progressive exemption method, provided the underlying tax treaty allows it. Under this method, when determining the Hungarian branch's CIT base, the income taxable abroad is also considered, which may cause (part of) the taxable income attributable to Hungary to be taxed at a higher effective tax rate.

Joint venture

There are no special tax rules for joint ventures in Hungary.

Choice of acquisition funding

A company may consider the following ways of financing the acquisition:

— equity financing

— debt financing through a loan (either provided directly by a shareholder or via a related or unrelated third party)

— a combination of equity and debt financing.

Debt

The main advantage of using debt for funding an acquisition as opposed to equity is the potential tax-deductibility of interest payments (see below). The debt might be borrowed from a related party or a bank. If the debt is borrowed from a related party, thin capitalization and transfer pricing rules should be considered.

Deductibility of interest

All interest-bearing liabilities are subject to thin capitalization rules in Hungary, except those from financial institutions and — as of 1 January 2012 — interest-free liabilities against related parties. According to the current rules, the average daily amount of the equity must be compared with the average

daily amount of loans. Under these rules, 'liability' means the average daily balance of outstanding loans, outstanding debt securities offered privately, bills payable (except for bills payable on suppliers' debts and bank loans) and interest-free related-party liabilities.

As of 1 January 2012, the amount of liabilities could be decreased by the daily average amount of financial receivables. As of 1 January 2013, receivables from supplied goods and services are not considered against liabilities. 'Equity' means the average daily balance of subscribed capital, capital reserve, profit reserve and tied-up reserves. Thus, the thin capitalization regulation covers interest on loans granted by related and unrelated parties and also extends to bonds and other loan securities issued exclusively to one party (closed securities).

If the ratio exceeds 1:3, the portion of the interest exceeding the limit is non-deductible for CIT purposes. There are no other restrictions regarding interest payments. As a result, all interest not subject to thin capitalization rules on an entity's external borrowings is tax-deductible on the same basis the interest is recognized for accounting purposes. However, general transfer pricing rules should also be taken into account; the interest applied between related parties should be at arm's length.

As of 1 January 2010, the special tax treatment of related-party interest was abolished. As a result, 100 percent of interest received from a related party is now taxable.

If the interest payment is not at arm's length, the CIT base of the company should be modified accordingly. If the payable interest rate is higher than the arm's length interest rate, the CIT should be increased by the difference. By contrast, the tax base can be reduced where the interest is lower than the arm's length rate, provided this difference is subject to an income tax at the creditor's level.

Taxpayers are obliged to prepare detailed transfer pricing documentation by the deadline for the submission of the company's annual CIT return. These records do not have to be filed with the tax return itself but must be available at the time of the tax authority investigations.

Interest income is exempt from local business tax in all cases (except for banks and licensed financial service providers). Recently, debt pushdowns have been subject to increased scrutiny by the Hungarian Tax Office, and many cases are now pending before the office and/or Hungarian courts. Before entering any such transaction, applying for a binding ruling is highly recommended. For now, there remains a relatively good chance for a positive result.

In line with the accounting practice changes, foreign taxes that correspond to corporate tax do not have to be added to pre-tax profits since these taxes are not accounted for as expenditures in the profit and loss.

Withholding tax on debt and methods to reduce or eliminate it

Hungary has concluded a comprehensive network of bilateral tax treaties for the avoidance of double taxation, based mainly on the OECD Model Convention. These treaties set reduced rates of WHT for dividends, royalties and interest income. For royalties and interest paid from Hungary, domestic legislation provides unilateral exemption, irrespective of double tax treaties.

Between 1 January 2004 and 1 January 2010, no WHT applied on interest paid to foreign companies, regardless of the residence of the interest recipient.

WHT on interest, royalties and certain service fees was re-introduced to the Hungarian legislation in 2010 but then abolished as of 1 January 2011.

As noted earlier, WHT on dividends was abolished from 1 January 2006.

Checklist for debt funding

— Consider whether the level of profits would enable the deductibility of interest.

— Consider the debt-to-equity ratio for the purposes of thin capitalization rules.

— Set arm's length interest rates and prepare transfer pricing documentation.

Equity

In certain cases, the use of equity might be more advantageous for the buyer to fund an acquisition. For example, if the company has a high debt-to-equity ratio (above 3:1), the use of debt would be disadvantageous because, under the thin capitalization rules, interest payments over the allowed ratio would not be tax-deductible.

Hybrids

There are no special tax rules for hybrid financing structures in Hungary. Deemed deductions are arguably available on certain hybrid instruments, provided, as mentioned above, that this difference is subject to an income tax at the creditor's level. KPMG in Hungary highly recommends seeking a Hungarian binding ruling before the transaction.

Discounted securities

There are no special tax rules for the treatment of discounted securities in Hungary. The tax treatment of such securities follows the accounting treatment.

Deferred settlement

The taxation of capital gains derived from preferential transformation may be deferred, if all prescribed criteria for the preferential transformation in the Act on Corporate Income and Dividend Tax are met.

Other considerations

In addition to pure share and asset deals, mergers can provide further tax planning opportunities in Hungary. According to the Hungarian accounting rules, a merger may take place at book value or market value. For a merger at book value, the value of the assets and liabilities of the dissolving party is the same in the books of the legal successor. In this case, there are no tax consequences. For a merger at market value, the assets and liabilities of the dissolving party are re-valued to market value.

According to the corporate tax law, any revaluation difference is taxable in the final tax return of the dissolving party. It is possible to defer the taxation of the revaluation difference where the merger is deemed to be preferential in line with the EU Mergers Directive.

A former advantage of a merger was that the losses of the legal predecessor could be carried forward during a transformation, taking into account the general rules; however, due to the amendments to the Act on Corporate Income and Dividend Tax, the restrictions noted earlier should be considered and the amount of carry forward losses would be limited.

Concerns of the seller

As noted earlier, capital gains generally are subject to 9 percent CIT, but may be tax-exempt if the capital gain is realized on an announced participation and all other criteria are met.

Generally, Hungary does not tax gains realized by non-resident companies, so a capital gain realized by a non-resident on the sale of shares in Hungarian company is not subject to CIT. However, as of 1 January 2010, if the shares qualify as shares in a real estate company, capital gains on the sale of such shares are subject to CIT at 9 percent in certain cases, unless the selling company is registered in a country with which Hungary has a tax treaty that disallows source country taxation.

If the seller of the shares is an individual, the capital gain on the sale of shares probably is subject to personal income tax.

Company law and accounting

As of 15 March 2014, the new Civil Code includes the general provisions on how companies may be formed, operated, reorganized and dissolved in Hungary. A separate act — Act on Transformations, which also applies as of 15 March 2014 — includes detailed rules regarding transformations, mergers, demergers and termination without legal successor of legal persons.

The Civil Code recognizes four basic legal forms for carrying out business activities.

According to the new Civil Code, business associations with legal personality are unlimited partnerships in the form *Közkereseti társaság* (Kkt.) and *Betéti társaság* (Bt.), companies with limited liability such as limited liability companies (*Korlátolt felelösségü társaság* — Kft.) and companies limited by shares, of which there are two types: private limited companies (*Zártkörüen müködö részvénytársaság* — Zrt.) and public limited companies (Nyilvánosan müködö részvénytársaság — Nyrt.).

The most common types of companies in Hungary are limited liability companies and private limited companies. Generally, when a company changes company form (such as transformation from Kft. to Zrt.), the accounting and tax rules for mergers are applicable, including the rule that allows the assets and liabilities of a transforming party to be revalued to market value during the transformation.

According to the Civil Code, business associations may change company form, merge (amalgamation and assimilation) and demerge (division and separation). In assimilation, the target business association terminates and its assets devolve to the surviving business association as legal successor. The company that survives the merger becomes the general legal successor of the non-survivor. An amalgamation is a process in which two companies merge into a newly formed company and simultaneously the merging companies cease to exist. The new company is the general legal successor of all properties, rights and obligations (liabilities) of the former companies.

For all forms of business associations, if the business association's supreme body has resolved in favor of the merger, the executive officers of the combining business associations have to prepare the draft merger agreement. The required content of this agreement is set out in the Civil Code and the respective rules of the Act on Transformations.

Pursuant to the Civil Code, a demerger may take the form of a division or a separation. The supreme body of a business association may divide the demerged business association into several business associations.

In a division, the business association being divided terminates and its assets devolve to the business associations being established as legal successors through transformation.

In the course of a separation, the business association from which separation is effected continues to operate in its previous form following alteration of the articles of association, and a new business association is established with the participation of the separating members (shareholders) and use of part of the assets of the business association.

The supreme body of the business association also examines which members intend to become members of the legal successor business association. Members of the original business association can become members of one or all of the legal successor business associations. The executive officers of the business association prepare the draft terms of the demerger with content required by the Civil Code and the respective rules of the Act on Transformations.

The legal successors of demerging business associations are liable for the obligations of the original business association before demerger in accordance with the demerging agreement.

There is no pre-company period for a new business association coming into being through transformation. The new business association may choose any corporate form for operation, provided the requirements on the subscribed capital for the given corporate form are met.

The members (shareholders) of the legal predecessor business associations may be declared liable for the obligations of the successor if the legal successor was unable to meet them. Should an unlimited liability member of a business association become a limited liability member in the course of the transformation, that member remains liable on an unlimited basis for the obligations of the legal predecessor acquired before the transformation for 5 years after the transformation.

Limited liability members (shareholders) leaving a business association in the course of a transformation remain liable on a limited basis for the obligations of the legal predecessor for 5 years after the transformation.

The business association's supreme body must pass a resolution on the transformation on two occasions. On the first occasion, based on the proposal of the executive officers and the supervisory board, the business association's supreme body must establish whether the members of the business association agree on the intention to transform and decide into what form of business association the business association shall transform. If the business association's supreme body agrees on the transformation, the executive officers shall prepare:

— the draft balance sheet and an inventory of assets of the business association undergoing transformation

— the draft (opening) balance sheet, an inventory of assets and draft articles of association of the business association being established through the transformation

— the proposal on rendering accounts with those persons not intending to take part in the legal successor business association as members.

The business association's supreme body must then resolve to approve these drafts. Within 8 days of the second decision, the business association must publicly announce its decision on its transformation.

A business association undergoing transformation may revalue its assets and liabilities as shown in the balance sheet of the report prepared pursuant to the Accounting Act.

If a business association does not possess equity corresponding to the minimum subscribed capital prescribed for its form of business association in 2 consecutive years and the members (shareholders) of the business association do not provide for the necessary equity within 3 months after approval of the report prepared pursuant to the Accounting Act for the second year, the business association is required to resolve for transformation into a different business association within 60 days after the deadline expires.

The transformation is effective as of its date of registration by the companies' court. The business association being established through transformation is the legal successor of the business association undergoing transformation. The legal successor is entitled to the rights of the legal predecessor, and the obligations of the legal predecessor passes to the legal successor, including obligations contained in any collective agreement concluded with the employees.

Merging companies must prepare balance sheets and inventories of assets on two occasions: drafts must be prepared to support the decision of the owners on the merger, and final documents must be prepared on the date of the merger (i.e. the date when the merger is registered by the court).

Companies ceasing operations (which merge into others) as a result of the merger must prepare annual financial statements on the date of the merger. The merger date constitutes a year-end for such companies, such that all closing procedures must be carried out with reference to this date.

The date of the merger does not constitute a year-end for companies continuing to operate in the same company form after the merger, so they must not close their books — the transformation must be accounted for in the normal course of bookkeeping.

A balance sheet prepared pursuant to the Accounting Act may be accepted as the draft balance sheet of the business association undergoing transformation if the reference date is no more than 6 months earlier than the second decision on the transformation.

Pursuant to the Accounting Act, a business association undergoing transformation may revalue its assets and liabilities as shown in the balance sheet of the report prepared. The draft balance sheet and an inventory of assets must be examined by an auditor and, if a supervisory board operates at the business association, by the supervisory board. The usual auditor of the business association is not entitled to conduct this examination. The value of the assets of the business association and the amount of its equity may not be established at a value that is higher than the value accepted by the auditor.

Group relief/consolidation

There is no tax-consolidation regime in Hungary for CIT purposes. Group taxation can be chosen only for VAT purposes.

Transfer pricing

Hungary's transfer pricing rules broadly comply with the OECD transfer pricing guidelines. The rules allow the tax authorities to adjust taxable profits where transactions between related parties are not at arm's length. The current legislation prescribes not only the methods applicable for determining a fair market price but also the way in which these must be applied. The taxpayer may calculate the fair market price using any method, provided it can prove that the market price cannot be determined by the methods included in the Act on Corporate Income and Dividend Tax and that the alternative method suits the purpose.

Since 2005, these rules should also be applied to transactions where registered capital or capital reserve is provided in the form of non-cash items, reduction of registered capital, or in-kind withdrawal in the case of termination without successor, if this is provided by or to a shareholder that holds majority ownership in the company.

Taxpayers are obliged to produce detailed transfer pricing documentation. This documentation should be prepared by the deadline for the submission of the annual CIT return of the company. These records do not have to be filed with the tax return itself but must be available at the time of the tax authority investigations.

'Related parties' are defined in the Act on Corporate Income and Dividend Tax to include the following parties for transfer pricing purposes:

— the taxpayer and an entity in which the taxpayer has a majority interest, whether directly or indirectly, according to the provisions of the Civil Code, which means that it controls more than 50 percent of the votes

— the taxpayer and an entity that has a majority interest in the taxpayer, whether directly or indirectly, according to the provisions of the Civil Code

— the taxpayer and another entity where a third party has a majority interest in both the taxpayer and such other entity, whether directly or indirectly, according to the provisions of the Civil Code

— a foreign enterprise, its domestic place of business, and the business premises of the foreign enterprise; the domestic place of business of a foreign enterprise and the entity that is in the relationship defined earlier with the foreign enterprise

— the taxpayer and its foreign place of business, and the foreign place of business of the taxpayer and such entity that is in the relationship defined earlier

— as of 1 January 2015, the taxpayer and the other person may qualify as related party if dominating influence is exercised in business and financial decisions due to common management.

Majority interest also occurs where any party has the right to appoint or dismiss the majority of executive officers and supervisory board members. The voting rights of close relatives are taken into account jointly.

The default penalty for not preparing the transfer pricing documentation is HUF2 million for each missing or incomplete document set. As of 1 January 2012, the default penalty could be increased for repeated transgressions.

Recent changes to Hungary's transfer pricing rules have simplified the requirements for transfer pricing documents as of 2012. Under certain specified circumstances, the use of EU master files will be accepted and the documentation can be prepared in a language other than Hungarian.

Dual residency

There are no special rules for dual resident companies in Hungary.

Foreign investments of a local target company

The Act on Corporate Income and Dividend Tax includes CFC provisions, which aim to prevent Hungarian companies from transferring their profits to low-tax jurisdictions. According to the legislation in effect from 18 January 2017, 'CFC' is defined as

— a foreign entity, in which a Hungarian tax resident company (by itself or together with its associated enterprises):

  — holds a direct or indirect participation of more than 50 percent of the voting rights

  — owns directly or indirectly more than 50 percent of registered capital, or

  — is entitled to receive more than 50 percent of the after-tax profit of that foreign entity

and, simultaneously, the actual corporate tax paid by the foreign entity is less than half of what the foreign entity would have paid if it were a Hungarian resident entity (using Hungarian accounting and tax rules). As a result, a foreign entity with an effective tax rate lower than about 4.5 percent (assuming the foreign rules are largely identical to the Hungarian rules) is caught by the CFC definition.

— a non-Hungarian branch/permanent establishment (PE) of a Hungarian resident company if the actual corporate tax paid by this non-Hungarian branch/PE is less than half of what its theoretical tax liability would have been if it were located within Hungary.

The above rules do not apply for a foreign company that has at least one direct shareholder with a minimum of 25 percent participation in it during the whole financial year, which (or which associated company) is listed on a recognized stock exchange for at least 5 years without interruption before the first day of the given financial year. Further, the above CFC rule does not apply if the foreign company or the non-Hungarian branch/PE carries on a substantive economic activity by itself (or by its associated companies with registered seat in the same country), as evidenced by relevant facts and circumstances.

According to the Hungarian regulation, 'relevant facts and circumstances underlying the substantive economic activity' means that the foreign company or the non-Hungarian branch/PE carries out manufacturing, agricultural, service provision, investment or commercial activity by employing more than one employee and using its own assets and the revenue generated from this activity is more than the 50 percent of the revenue of the company/branch/PE.

In calculating the 50 percent threshold, total revenue includes the revenue generated from these activities (by employing more than one employees and using the company's own assets) of all affiliated companies registered in the same country.

The application of Hungarian CFC rules may trigger various tax consequences. Hungary introduced a new anti-deferral rule as of 2010 for any undistributed profits in the CFC at the level of the Hungarian corporate shareholder.

Additionally, dividends distributed by a CFC cannot benefit from the participation exemption and thus are included in the Hungarian company's CIT base. Further, capital gains derived from the sale of participations in a CFC cannot benefit from the available participation exemption for CIT purposes and so they are fully taxable in Hungary.

Realized capital losses and expenses related to a reduction in the value of a holding in a CFC, or from the disposal of such holding, increase the CIT base of a resident company insofar as the losses and expenses exceed the income booked in relation to the same transaction.

Payments made to CFCs may be not deductible for CIT purposes unless the taxpayer proves they are directly related to the operation of its business.

Comparison of asset and share purchases

Advantages of asset purchases

— No assets other than those specifically identified by the buyer are transferred.

— No employment or contractual relationships need to be assumed from the seller unless the buyer wishes to do so; thus the buyer could offer employment to the people it needs under revised salary and working conditions.

— Purchase price may be depreciated for tax purposes.

— Historical tax liabilities of the seller are not inherited.

Disadvantages of asset purchases

— Possible need to renegotiate supply, employment and technology agreements.

— If real estate is transferred, real estate transfer tax applies.

— Arm's length consideration should be paid on the transfer of selected assets between related parties.

— VAT is due on the asset acquisition, which can lead to cash flow timing issues and, in the worst case, a VAT cost.

Advantages of share purchases

— Potentially lower capital outlay (purchase net assets only).

— May benefit from tax losses of the target company (subject to certain criteria as of 2012).

— May gain benefit of existing supply or technology contracts.

— No VAT to pay.

— Buyer may benefit from all permits, licenses and authorizations, unless stipulated otherwise.

Disadvantages of share purchases

— Buyer automatically acquires any liabilities of the target company (including tax liabilities).

— Liable for any claims or previous liabilities of the target.

— Very limited tax deduction possibilities for goodwill in relation to the purchase price.

— Could be subject to real estate transfer tax as of 2010.

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Iceland

Introduction

An Icelandic business enterprise may be organized as a limited liability company: either a public limited liability company (hf.) or a private limited liability company (ehf.). Iceland has incorporated European Union (EU) corporate law directives in its domestic legislation, so Icelandic corporate laws are largely based on EU directives.

As Iceland is not a member of the EU, the EU Merger Directive 90/434/EEC does not apply in Iceland. In recent years, however, Iceland has implemented changes that incorporate legislation similar to the directive.

Other forms of business enterprises used in Iceland are sole proprietorships, partnerships and cooperative societies. Partnerships can be registered as separate taxable entities; if so, they are subject to the payment of income tax. Where the partnership is not registered, each partner is subject to tax on its respective profit. A partner may be a limited liability company. A cooperative society is liable for income tax.

The discussion below covers limited liability companies only.

Recent developments

Icelandic legislation regarding mergers and acquisitions (M&A) has changed recently as follows:

— Limitations on the deduction of interest paid to related parties have been introduced.

— Formal transfer pricing rules have been implemented.

— The Act on Stamp Duty has been replaced by a new one that only applies to transfer of ownership of real estate and ships.

— According to Supreme Judgment no. 555/2012, interest on loans assumed to acquire shares is not deductible where the loans are merged into the acquired company.

The following discussions of Icelandic tax are based on current tax legislation.

Asset purchase or share purchase

A foreign buyer may acquire an Icelandic company (the target company) by purchasing either its assets or its shares.

A foreign company that acquires the Icelandic assets of an Icelandic company and carries on the business through an Icelandic branch is normally regarded as having a permanent establishment in Iceland. As such, the foreign company is taxable in Iceland in accordance with domestic Icelandic tax legislation and any tax treaty between Iceland and the foreign company's country of residence.

Alternatively, a foreign buyer may acquire the underlying business through an Icelandic subsidiary. It takes only a few days to establish a company in Iceland, and a newly established company can be acquired from KPMG in Iceland.

Matters related to asset acquisitions are discussed below, followed by a discussion of share acquisitions.

Purchase of assets

A purchase of assets usually results in an increase to the base cost of those assets. The increase is likely taxable in the hands of the seller.

Purchase price

— For tax purposes, it is necessary to apportion the total consideration among the assets acquired. Generally, the purchase agreement is required to specify the price at which each asset is bought.

— For tax purposes, the purchase price is the price paid converted into Icelandic krónur (ISK) on the date of purchase.

— Assets transferred between associated parties must be transferred at fair market value.

— Gains or losses on receivables and debts in foreign currency must be included in the seller's taxable income.

Goodwill

— Goodwill paid for a business can be depreciated for tax purposes at rates from 10 to 20 percent each year using the straight-line method. Where the allocation of the sale proceeds has not been agreed to, the tax authorities estimate the allocation.

— Patents, copyrights and similar rights can be depreciated for tax purposes at rates from 15 to 20 percent each year using the straight-line method. These rights may be written off over their economic life where the economic life is shorter than 5 years.

Depreciation

Depreciation for income tax purposes is calculated using the straight-line method for immovable property, non-sustainable natural resources, acquired intellectual property rights and acquired goodwill. Gradual depreciation is employed for movable property.

Assets subject to ordinary depreciation are divided into various categories, with different annual depreciation rates for each. The rates within a category are optional and can be changed from one year to another.

Depreciation categories

Movable property	
Ships, equipment for ships and passenger cars	10–20%
Aircraft and flight equipment	10–20%
Industrial machinery and equipment	10–30%
Office equipment	20–35%
Other machinery, equipment and cars	20–35%

Other assets	
Buildings and other structures, e.g. office and commercial buildings	1–3%
Industrial plants, storage facilities, etc.	3–6%
Quays and greenhouses	6–8%
Wells, electric transmission lines, work camps	7.5–10%
Acquired goodwill	10–20%
Patents, copyrights and other similar rights	15–20%

Source: KPMG in Iceland, 2018

When an asset is purchased, there is a step-up in its cost base for tax purposes.

The depreciation base of movable property is its book value at the beginning of each year. The depreciation base of other depreciable assets is cost price.

The depreciation period of an asset starts at the beginning of the year in which the asset is put into use. Residual value equal to 10 percent of the asset's original value remains on account until the asset is scrapped or sold. Accelerated and/or extraordinary depreciation or write-offs are deductible from income in certain limited cases. No depreciation is expensed on an asset in the year of sale.

The cost of acquiring production rights in agriculture can be fully amortized over a period of 5 years with equal annual amounts.

The following assets can be fully expensed in the year of acquisition or amortized with equal annual amounts over a period of 5 years:

— start-up cost, such as registration cost and the cost of acquiring necessary official permits and licenses

— expenses relating to trial runs, marketing, research, patents and trademarks.

Where the cost of an asset or group of assets is less than ISK250,000, the cost may be fully expensed in the year of acquisition.

Tax attributes

Tax losses are not transferred on an asset acquisition. They remain with the company and are not extinguished. No previous liabilities of the selling company are inherited. There is also no acquisition of a tax liability on retained earnings.

On purchase of the asset, a step-up of the cost base for tax purposes is obtained.

It is possible to acquire a part of a business with an asset purchase. Profitable operations can be absorbed by loss-making companies in the acquirer's group, thereby effectively gaining the ability to use the losses of the group members.

Value added tax

Value added tax (VAT) is levied at the general rate of 24 percent. A reduced rate of 11 percent applies to a number of goods and services.

The disposal of operating assets from a tax-registered business triggers VAT where the sale covers only operating assets and not the sale of the business or an independent part of it. A sale of the business or part thereof can occur tax-free if the buyer is registered for VAT purposes.

In tax practice, a series of criteria have been developed to determine what is considered to be all or part of the business. A merger normally has no VAT consequences, provided the conditions for VAT exemption exist.

Where the absorbed company owned real estate used for a VAT-registered business, consideration should be given to VAT and whether there is input tax encumbrance.

Article 12 of the VAT Act provides for exempted taxable turnover. If one of the exemptions applies, the transaction is not subject to VAT (zero rate). However, entities involved in exempt transactions can still claim input tax. Article 12 exempts from VAT the following items:

— exported goods and labor and services provided abroad

— sales of services to parties neither domiciled nor having a place of operations in Iceland, provided that the services are wholly used abroad (e.g. services of consultants, engineers, lawyers, accountants and other similar

specialized services, except for labor or services related to assets or real property in Iceland)

— a service of refunding VAT to parties domiciled abroad

— shipbuilding and repair and maintenance work on ships and aircraft and their fixed equipment, and materials and goods used or provided by the company doing the repair work (boats under 6 meters in length, pleasure boats and private aircraft are excluded)

— rental of ships and aircraft (boats under 6 meters in length, pleasure boats and private aircraft are excluded).

Transfer taxes

The new Act on Stamp Duty, which took effect in 2014, levies stamp duty only on instruments transferring ownership of real estate and ships over 5 gross tons.

Deeds and purchase agreements on the transfer are taxed at 0.8 percent for individuals and 1.6 percent for companies. The tax base for real estate is the officially registered value (the government issues the valuation for each real estate property). The tax base for ships is the purchase price according to the purchase agreement (or other document in relation to the transfer of ownership), but it is never less than the ship's secured debts.

As a result of amendments to the Act on Stamp Duty that took effect January 1, 2016, stamp duty does not apply when ownership transfers following a company law merger or division, or when a private limited company is converted into a public limited company.

Before the new act took effect in 2014, instruments transferring ownership in relation to mergers were considered exempt from the stamp duty as a Supreme Court judgment found that there was no change in ownership. Following the changes that came into force in January 2016, stamp duties in relation to mergers and divisions have been lifted again.

Purchase of shares

There are no immediate Icelandic tax consequences for a foreign company when it acquires the shares of an Icelandic company. Therefore, where goodwill is included in the value of shares, depreciation for tax purposes is permitted.

There is no possibility for a tax-free step-up in the tax basis of the acquired company's assets.

It is not possible to obtain clearance from the tax authorities giving assurances that a potential target company has no tax liabilities or is not involved in a tax dispute.

A distinction must be made between taxable and tax-exempt mergers.

Taxable mergers

Where a merger is carried out according to corporate law but the conditions for a tax-exempt merger (see below) are not met, the absorbed company is deemed to be liquidated for tax purposes and the assets are deemed to be transferred at market price to the absorbing company. Any gain is taxable to the absorbed company.

Consequently, the absorbing company may use the market value of the assets received as its depreciation basis for tax purposes.

Usually, the absorbed company is acquired in exchange for shares in the absorbing company. The shares are paid to the shareholders when the absorbed company is dissolved. The difference between the purchase price of the shares in the absorbed company and their market value (or the market value of any other payment) is taxable to the shareholder as a capital gain.

The absorbing company cannot carry forward the losses of the absorbed company. The absorbing company can carry forward its own realized losses for 10 years under the normal rule, irrespective of the merger.

Tax-exempt mergers

A tax-exempt merger can be performed by two or more companies, which can be held by a foreign holding company or foreign investors.

A merger is tax-exempt where the following conditions are met:

— The absorbed company must be totally absorbed by the absorbing company, including all assets, liabilities and stockholder's equity, and the shares in the absorbed company must be paid for only with shares in the absorbing company. No cash payment is allowed.

— It has been interpreted that these conditions is not met where the absorbing company buys shares in a company and pays for them with something other than shares in the absorbing company with the intention of absorbing it and does so in the near future. The absorbing company (the buyer) is not considered to be the shareholder of the absorbed company in this situation. The former shareholders (the sellers) remain the shareholders and the consideration is deemed to have been cash.

The tax-exempt merger provisions have the following consequences:

— The absorbed company is taxed under the normal rules up to the merger date.

— The transfer of assets to the absorbing company is not treated as a sale.

— The tax position of the absorbed company (e.g. depreciation balances on fixed assets) is taken over by the absorbing company.

— The shareholders of the absorbed company are deemed to have acquired their shares in the absorbing company at the same time and price as their (cancelled) shares in the absorbed company.

Following legislative amendments that entered into force early 2016, the transfer of real estate or ships over 5 tons

from the absorbed company to the absorbing one is no longer subject to stamp duties. No stamp duty applies on the issuance of new shares.

A cross-border tax-exempt merger is now possible. Where the acquiring company meets the requirements stipulated below, the merger has no tax effect for the shareholders.

For the company, its assets are considered to be sold at market value. However, under a provision effective from 2014, taxable income of the company arising from a merger that meets the criteria of tax-free merger can be deferred evenly for the following 5 years. The deferred payments are subject to interest equal to the general non-indexed interest rate issued by the Central Bank, and collateral must be posted where the deferred tax debt exceeds ISK50 million.

Conditions for the tax deferral are as follows:

— The acquiring company must be resident of the European Economic Area (EEA), European Free Trade Association (EFTA) or the Faroe Islands.

— The acquired company needs to have submitted tax returns for the current and previous years.

— The acquiring company must submit its annual financial statements each year, whereby information about the acquired assets can be found.

— Where a company is resident in a low-tax jurisdiction (two-thirds of the Icelandic income tax), the company needs to demonstrate that it has real economic activity.

— A tax treaty or other international treaty must exist between states that can be used to obtain all necessary information.

As of 2016, no collateral must be posted where it is possible to obtain all necessary information based on a tax treaty or another international agreement.

Further, if the assets of the merged Icelandic company will become part of an Icelandic permanent establishment and still be subject to taxation in Iceland, they can be exempted from the taxation. As of 2016, the same rules apply to a cross-border division.

Cross-border change of domicile

If a limited liability company transfers its domicile or assets to another EEA or EFTA country, or the Faroe Islands, the transfer does not result in taxable income for the company or the shareholders, provided that such transfers are authorized by the companies act.

This rule does not apply if the companies or assets are transferred to a low-tax jurisdiction unless it can be demonstrated that the companies are engaged in real operations.

The provisions on cross-border mergers also apply to cross-border domicile changes, so any transfer of assets is subject to tax as if the assets were sold. When assets are transferred, payments of any taxes that would be levied due to the change of domicile are the responsibility of the Iceland-domiciled company surrendering the assets.

Tax indemnities and warranties

In the case of negotiated acquisitions, it is usual for the buyer to request, and the seller to provide, indemnities and/or warranties with respect to any undisclosed taxation liabilities of the company to be acquired. The extent of the indemnities or warranties is a matter for negotiation.

With negotiated acquisitions, it is usual for the seller to make the books of the target company available for a due diligence review by the prospective buyer. A normal part of the due diligence process involves an in-depth review of the tax affairs of the potential target company by the advisers to the buyer.

Tax losses

In general, losses may be carried forward for 10 years. No carry-back is allowed.

If the foreign company absorbs the underlying business, rather than the shares of an Icelandic company, the absorbing company cannot use pre-acquisition losses. If the business that created the loss has ceased, the right to use the loss lapses.

When a tax-exempt merger is performed, the acquiring company can only carry forward losses of the absorbed company if the following conditions are met:

— The absorbing company shall run a business related to the business of the absorbed company.

— The absorbed company shall have some assets at the time it is dissolved.

— The absorbed company shall run some business at the time it is dissolved.

— The merger must have a business purpose; a tax planning purpose is allowed, but there has to be some other business purpose as well.

— The carried forward losses must have been realized in a business of the absorbed company that is related to the business of the absorbing company.

Pre-sale dividend

As the tax treatment of dividends and capital gains are the same, there is little difference for Icelandic tax purposes. However, if the companies cannot apply for joint taxation, there is a withholding tax (WHT) on the dividends, whereas there is normally no WHT for capital gains.

Transfer taxes

Stamp duty is only levied on instruments transferring ownership of real estate and ships over 5 gross tons (see above). However, exemption applies to cases of company law

mergers and divisions and transformations of private limited companies to public limited companies.

Tax clearances

It is possible to apply to the Internal Revenue for a binding ruling before a merger to get an assurance on whether or not the merger will qualify as tax-exempt.

Choice of acquisition vehicle

The following vehicles may be used to acquire the shares or assets of the target:

— branch of a foreign company

— subsidiary of a foreign company

— treaty country intermediary

— local holding company

— joint venture.

Generally, the advantages and disadvantages of the different vehicles must be considered case-by-case.

Local holding company

Profits and losses within an Icelandic group of companies may be equalized by means of consolidated taxation. Group consolidated taxation is possible between a parent company and subsidiaries in which it holds 90 percent or more of the shares, either directly or indirectly, subject to certain other conditions.

Foreign parent company

The foreign buyer may choose to make the acquisition itself. This might cause future tax problems in Iceland, as Iceland taxes the gains of non-residents disposing of Icelandic assets at the standard rate and levies WHT on dividends and interest (unless a tax treaty reduces or eliminates such taxation).

However, if the parent company is a limited liability company within the EEA, capital gains from the sale of shares in Icelandic companies and dividends received from Icelandic companies can be deducted in full so that no tax applies.

Non-resident intermediate holding company

If the foreign country taxes capital gains and dividends received from overseas, an intermediate holding company resident in another territory could be used to defer this tax and perhaps take advantage of a more favorable tax treaty with Iceland. However, the buyer should be aware that certain Icelandic treaties contain treaty shopping provisions that may restrict the ability to structure a deal in a way designed solely to obtain tax benefits.

Local branch

A non-resident company would normally carry on business in Iceland through an Icelandic corporation (subsidiary) or through a registered branch. The tax rate of the branch in Iceland depends on the corporate form of the headquarters.

If the headquarters are in a form corresponding to the form of limited liability companies in Iceland, the tax rate is 20 percent.

According to a recent tax authority interpretation, Icelandic branches of companies registered within the EEA, EFTA or Faroe Islands may benefit from the same deductions for received dividends and capital gains as Icelandic companies.

However, Icelandic branches cannot be consolidated with other Icelandic companies. This treatment may be a breach of the non-discrimination article in a relevant tax treaty and Iceland's obligation under the EEA agreement.

Joint venture

No special tax legislation applies to joint ventures.

Choice of acquisition funding

A buyer using an Icelandic acquisition vehicle to carry out an acquisition for cash needs to decide whether to fund the vehicle with debt, equity or a hybrid instrument that combines the characteristics of both. The principles underlying these approaches are discussed below.

Debt

— Interest on loans assumed for the purpose of acquiring shares is deductible, provided the loans were taken for the purpose of providing, securing or maintain income in that company. The deduction is made on an accrual basis. Iceland has no specific thin capitalization rules.

— Companies must account for interest accrued and paid in the period to which it applies.

— Interest paid to non-residents is subject to WHT.

— Company law prohibits a company from lending or giving security for the purchase of its own shares or shares in its parent company.

— Where a loan is made between associated companies at below-market rate, a transfer pricing adjustment can be made.

— Gains or losses on receivables and debts in foreign currency must be converted into ISK and included in a company's taxable income.

Deductibility of interest

Usually, interest payments are deductible from the company's income base.

Where a loan is made between associated companies at below-market rate, a commercial rate (arm's length) of interest is imputed, the lender is subject to corporate tax on the difference.

Interest on loans assumed for the purpose of acquiring shares is not deductible where the acquiring company is merged into the acquired company, according to Supreme Judgment no. 555/2012. In such cases, the debt is not considered have been taken for the purpose of providing, securing or maintaining income in that company, so interest on the loans is not deductible.

Limitation of deduction of interest paid to related parties

A limitation on the deduction of interest expense applies if the lender is a related party. Under this new rule, a taxpayer´s deduction of net interest expense (and economically equivalent payments, is limited to 30 percent of the company´s taxable operating profit (i.e. earnings before income taxes and amortization — EBITDA).

The rule lists four exceptions, i.e. the interest expense deduction limit does not apply in the following circumstances:

— Interest expense of taxable party from the loan is less than ISK100 million.

— The lender has an unlimited tax liability in Iceland.

— The taxable party demonstrates that its equity ratio is no less than 2 percent below the equity ratio of its constituent group it is a part of.

— The taxable party is a financial corporation or an insurance company.

It has been proposed that the exception for lenders with unlimited Icelandic tax liability will be abolished, so that the interest deduction limitation would apply equally to all loans from related parties regardless of where the lender is a tax-resident. The amendment is expected to take effect as of 1 January 2019.

Withholding tax on debt and methods to reduce or eliminate it

Payments of interest by an Icelandic company to a non-resident are subject to a 12-percent WHT rate, which may be reduced or eliminated under a tax treaty.

Checklist for debt funding

— Interest payments may be subject to WHT.

— A tax treaty may reduce or eliminate such taxation.

— An application to the Internal Revenue must be made before any interest payment is made to benefit from a tax treaty.

— It is not necessary to apply each time a payment is made; one application per year is sufficient.

Equity

A buyer may use equity to fund its acquisition.

Dividends paid from Icelandic companies to foreign shareholders are subject to WHT of 22 percent when paid to individuals and 20 percent when the recipient is a legal entity. A tax treaty may reduce this rate. Where the parent company is a limited liability company within the EEA, capital gains from the sale of shares in Icelandic companies and dividends received from Icelandic companies can be fully deducted such that no tax liability arises.

Iceland does not levy stamp duty on debt or equity instruments.

Hybrids

The tax treatment of a financial instrument usually is determined by the instrument's substance rather than its form, based on a case-by-case analysis of the instrument's characteristics.

Redeemable preference shares are deemed to be equity where they are registered with the register of enterprises. The yield is taxed as dividends.

Convertible notes are regarded as loans until conversion. Payments made before conversion are taxed as interest. After conversion, the yield is taxed as dividends.

Discounted securities

Transactions involving securities between associated parties must be at fair market value.

Other considerations

Concerns of the seller

Tax-exempt mergers cannot take place unless all merging companies are Icelandic or within EEA, EFTA or Faroe Islands and certain requirements are met, as discussed above.

For the shareholders, a non-tax-free merger is treated as a sale in the hands of the shareholder.

Company law and accounting

An Icelandic business enterprise may be organized as a limited liability company: either a public limited liability company (hf.) or a private limited liability company (ehf.). Icelandic corporate laws are largely based on EU directives.

Other business forms used in Iceland are sole proprietorships, partnerships and cooperative societies. Partnerships can be registered as separate taxable entities; if so, they are subject to income tax (no net worth tax applies to companies in Iceland). Where the partnership is not so registered, each partner (which may be a limited liability company) is subject to tax on its respective profit. A cooperative society is also subject to income tax.

A common issue on transaction structuring arises from the provisions concerning financial assistance. Broadly, these provisions say that it is illegal for a limited liability company (or one of its subsidiaries) to give financial assistance, directly or indirectly, for the purpose of acquiring that company's shares. The scope of this prohibition in Icelandic corporate law is unclear.

Group relief/consolidation

Companies may opt for consolidated taxation where a company owns at least 90 percent of another company. Consolidated taxation means, among other things, that losses of one company can be offset against profits of other companies. Consolidated taxation cannot be extended to non-resident companies or permanent establishments of foreign companies.

Transfer pricing

The Icelandic Parliament recently approved a new provision regarding transfer pricing. Previously, a general anti-avoidance provision allowed the tax authorities to adjust prices of transactions where it could be demonstrated that the basis for that price was abnormal.

The new transfer pricing provision is based on the arm's length principle. Prices that are not in accordance with the principle may be adjusted using the Organisation for Economic Co-operation and Development's (OECD) transfer pricing guidelines. The definition of 'related party' extends to direct or indirect majority ownership and/or control of legal entities, and to individuals who are considered related by family.

Companies having over ISK1 billion in revenue or assets at the beginning of the year or at year-end must keep documentation about the nature and extent of transactions with related parties, the nature of the relationship and the basis of price decided. The documentation requirement refers to the OECD guidelines.

Country-by-country reporting

A parent company registered in Iceland owning subsidiaries abroad forms a multinational enterprise (MNE). As such, it is required to submit to the tax authorities country-by-country (CbyC) report containing information on its distribution of income and paid taxes, as well as the activities of the undertakings within each reporting jurisdiction.

The obligation to submit a CbyC report only applies to MNEs with revenues above ISK100 billion.

Dual residency

Under Icelandic tax law, an Icelandic-registered company is resident in Iceland and fully taxable in Iceland. Such a company may also be taxed as a resident of a foreign country where the foreign country uses the place of actual management criterion to determine residence. This criterion also applies under Icelandic tax law. If a tax treaty has been concluded with the country in question, the treaty normally defines the company as being resident in the country where the place of management is located.

Foreign investments of a local target company

Iceland implemented controlled foreign company (CFC) legislation with effect for income earned in or after 2010. Under these rules, where a non-resident company, fund, institution or other entity in a low-tax country is at least 50 percent owned or controlled, directly or indirectly, by resident taxpayers (corporate or individual), its profits, whether distributed or not, are attributed proportionately to its resident shareholders and taxed in the normal manner (corporate or individual income tax, respectively).

For this legislation to apply, all that is needed is for the parties owning directly or indirectly 50 percent or more of the low-tax entity to be Icelandic tax residents. There is no need for the Icelandic parties to be related or connected in any way.

The term 'low-tax country' is defined as a country where the general income tax rate on corporate profits is less than two-thirds of the Icelandic rate that would apply if the company were resident in Iceland.

This legislation does not apply where the controlled company, fund, institution or other entity is:

— resident in a treaty country that has a sufficient exchange of information article and its income is not mainly financial income

— resident and engaged in business activities in a country that is within the EEA and from which the Icelandic tax authorities are able to request all necessary information according to an international treaty.

Companies that fall under the CFC legislation could be subject to double taxation since the legislation does not take into account possible taxation of the foreign company.

The Minister of Finance and Economic Affairs has published a regulation (No 1102/2013) on how the CFC legislation applies.

Comparison of asset and share purchases

Advantages of asset purchases

— A step-up in the cost base for tax purposes is obtained.

— No previous liabilities of the company are inherited.

— No acquisition of a tax liability on retained earnings.

— Possible to acquire only part of a business.

— Greater flexibility in funding options.

— Profitable operations can be absorbed by loss-making companies in the acquirer's group, thereby effectively gaining the ability to use the losses.

Disadvantages of asset purchases

— Possible need to renegotiate supply, employment and technology agreements, and change stationery.

— A higher capital outlay is usually involved (unless the debts of the business are also assumed).

— May be unattractive to the seller, thereby increasing the price.

— Accounting profits may be affected by the creation of acquisition goodwill.

— Benefit of any losses incurred by the target company remains with the seller.

Advantages of share purchases

— Lower capital outlay (purchase of net assets only).

— Likely to be more attractive to the seller, so the price is likely to be lower.

— Purchaser may benefit from tax losses of the target company.

— Purchaser may gain the benefit of existing supply or technology contracts.

Disadvantages of share purchases

— Purchaser acquires unrealized tax liabilities for depreciation recovery on the difference between market and tax book value of assets.

— No deduction for the purchase price or underlying goodwill.

— Less flexibility in funding options.

— Losses incurred by any companies in the acquirer's group in years prior to the acquisition of the target cannot be offset against any profits made by the target company.

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Ireland

Introduction

Irish tax provisions on mergers and acquisitions (M&A) have been evolving gradually in recent years.

There have been no fundamental changes since the capital gains tax participation exemption was introduced in 2004. However, some recent legislative changes have been introduced, primarily affecting structures related to the acquisition of Irish property or mortgages deriving their value from Irish property. These changes mainly impact non-resident investors and greater care is now required in structuring Irish property acquisitions.

This report addresses three fundamental decisions facing a prospective buyer:

— What should be acquired: the target's shares or its assets?

— Choice of acquisition vehicle available to the buyer?

— How should the acquisition be funded?

Tax is only one area to consider in structuring an acquisition. Other areas, such as company law and accounting issues (which are outside this report's scope), are also relevant when determining the optimal structure.

Recent developments

Irish real estate funds

A new withholding tax (WHT) was introduced in Finance Act 2016 for certain distributions and redemptions of units from certain Irish real estate funds (IREF), with some limited exceptions primarily for EU/EEA regulated funds and pension funds. As of 1 January 2017, the new provisions impose a 20 percent Irish tax charge for investors in such funds unless an exemption applies. Foreign (non-Irish resident) investors were previously exempt from Irish tax on distributions/redemptions of units from such funds.

In broad terms, a fund is regarded as an IREF where 25 percent or more of the market value of its assets are directly or indirectly derived from Irish real estate (IREF assets). A separate tax regime applies to REITs.

The WHT applies to the amount of the distribution paid to the unit holder or the redemption proceeds that exceed the amount of accrued profits in respect of the relevant unit when the unit holder first acquired the unit.

As noted, the IREF WHT does not apply to certain types of 'good' investors, such as certain Irish and EU/EEA pension funds and certain Irish registered charities. Investors who qualify for an exemption from IREF WHT must provide the IREF with a declaration establishing the basis of their exemption.

Transfer taxes

Stamp duty is chargeable on documents that transfer ownership of property, when the document is executed in Ireland or the document relates to property in Ireland or things to be done in Ireland. The stamp duty rate for shares in a company that derive their value, or the greater part of their value, directly or indirectly from Irish situated immovable (subject to exceptions) has been increased to 6 percent from 6 December 2017. The rate of stamp duty for transfers of non-residential property has also increased to 6 percent (from 2 percent).

Securitization regime

Irish tax resident companies that meet the conditions of the securitization regime (Section 110 companies) are subject to corporation tax at 25 percent on their net accounting profits but are entitled to a tax deduction for interest on profit-participating loans (where the conditions are met).

Finance Act 2016 introduced new restrictions on the deductibility of interest arising on profit-participating loans where the Section 110 company holds 'specified mortgages' (loans that derive their value or the greater part of their value from Irish real estate). Any such specified mortgages are deemed to be held in a separate business (known as a 'specified property business').

In broad terms, the interest deductions for profit-participating loans in a specified property business are now restricted to the amount of interest that would have been payable on that loan had it been a non-profit participating loan entered into at arm's length.

The resulting taxable profits are taxed at the rate of tax applicable to all securitization activities (i.e. 25 percent).

Finance Act 2017 amended the definitions of 'specified mortgage' and 'specified property business' to include a business (or part of a business) that includes the holding and/or managing of shares that derive their value, or the greater part of their value, directly or indirectly, from Irish real estate.

Multilateral Instrument

Ireland is an active participant and supporter of the Organisation for Economic Co-operation and Development's (OECD) Action Plan on Base Erosion and Profit Shifting (BEPS). In June 2017, Ireland was one of 78 countries that signed the Multilateral Instrument (MLI) to implement tax treaty-related measures to prevent BEPS. Additional changes related to BEPS and the EU Anti-Tax Avoidance Directive (ATAD) will be made to Irish law in the coming years.

The Irish Government released on 12 September 2017 a Review of Ireland's Corporation Tax Code ("The Coffey Report"). The Coffey Report includes a number of recommendations for possible future legislative changes largely BEPS and transfer pricing related. The recommendations are now the subject of a public consultation.

Irish collective asset-management vehicle

Another significant Irish tax development was the introduction in 2015 of the Irish collective asset-management vehicle (ICAV), a new form of undertaking for collective investment in transferable securities (UCITS) funds and alternative investment funds (AIF).

The ICAV is a corporate structure designed specifically for investment funds. It is a corporate entity with separate legal personality and its own board of directors. Shareholders of the ICAV are entitled to participate in the profits of the ICAV attributable to their share class.

ICAVs are subject to the same tax regime as other Irish funds. There is no Irish income tax or capital gains tax at the fund level. Distributions made by an ICAV are subject to 41 percent tax where they are made to Irish investors. The new IREF WHT tax provisions noted earlier in this section apply to IREFs in the form of an ICAV. In other cases, there is no Irish WHT or exit charge on distributions to non-Irish investors and certain categories of Irish investors. There are no Irish transfer taxes on the issue, redemption or transfer of shares in an ICAV. An ICAV has access to Ireland's extensive tax treaty network, minimizing the impact of foreign WHTs on returns from investments.

Knowledge development box

Another important Irish tax development, introduced in Finance Act 2015, was the introduction of the knowledge development box (KDB). The KDB gives an effective 6.25 percent corporate tax rate on qualifying profits derived from qualifying intellectual property, including patented inventions and copyrighted software, that results from R&D activities. This was the first preferential intellectual property (IP) tax regime in the world in compliance with the OECD's recommendations. The KDB follows the OECD-endorsed 'modified nexus approach', which links the relief under the KDB to the proportion of qualifying research and development (R&D) expenditure being carried on by the company in Ireland as a percentage of the overall group R&D expenditure including acquisition costs. An uplift in the qualifying expenditure is allowed up to the lower of 30 percent of the qualifying R&D spend or the aggregate of acquisition costs in relation to a qualifying asset and group R&D outsourcing costs.

The relief is given by way of a deduction from profits equal to 50 percent of the profits derived from the qualifying IP assets, which is treated as a separate trade, for an effective tax rate of 6.25 percent. The relief is available to companies for accounting periods that start on or after 1 January 2016 and before 1 January 2021. A claim for the relief must be made within 12 months of the end of the relevant accounting period. The KDB does not affect the availability of capital allowances on the acquisition of IP.

Any relief available under the KDB will not increase the level of refundable R&D tax credits available.

The benefit of the KDB may be limited for multinational groups, which tend to undertake R&D activities globally on a joint and collaborative basis. The qualifying R&D activity undertaken in Ireland in relation to a specific intellectual property asset may amount to a small percentage of the overall expenditure on that asset, in which case only a relatively small percentage of income from that intellectual property would be eligible for the relief.

Intangible assets

Tax-relieving provisions relating to the acquisition of intangible assets that were introduced in 2009 are still applicable and beneficial in an M&A context. Traditionally, the majority of M&A transactions were structured as share purchases for reasons outlined later in this report. The tax-relieving provisions require careful consideration of the structuring of acquisitions involving substantial components of intellectual property.

Irish companies are entitled to claim a tax write-off for the capital cost of acquiring or developing qualifying intangible assets for the purposes of their trade. Where such qualifying intangible assets are amortized or depreciated for accounting purposes, the tax write-off is available in line with the accounting write-off.

Alternatively, if the qualifying intangible asset is not amortized or depreciated for accounting purposes, or indeed has a very long life, a company can elect to take the tax write-off over

a 15-year period. A rate of 7 percent applies for years 1 to 14, and a 2 percent rate applies for year 15. Tax relief is also available where the asset is impaired in any 1 year.

The definition of 'qualifying intangible assets' is broad and encompasses patents, design rights, brands, trademarks, domain names, computer software acquired for commercial exploitation and certain knowhow, along with applications for the grant of registration of these items. Goodwill qualifies to the extent that it is directly attributable to qualifying intellectual property. The definition of 'goodwill' was expanded in Finance Act 2014 to include customer lists, apart from where the customer lists are acquired in connection with the transfer of a business as a going concern.

Certain restrictions and anti-avoidance measures apply to the relieving provisions. Primarily, any activity involving a specified intangible asset on which relief is being claimed must be treated as a separate activity for these purposes. Relief for capital allowances and certain interest costs is restricted to 80 percent of the annual income arising from this separate trade. This restriction was removed for accounting periods beginning on or after 1 January 2015. However, it was reintroduced in the Finance Act 2017, effective from 11 October 2017. As such, going forward it is necessary to keep track of the dates the relevant expenditure was incurred to correctly apply the restriction measures. Unused allowances or interest can be carried forward to future accounting periods.

Tax residency

Under changes introduced in Finance Act 2013 and Finance Act 2014 and effective as of 1 January 2015, an Irish incorporated company is regarded as tax resident in Ireland unless it is treated as tax resident in another jurisdiction with which Ireland has concluded a tax treaty and is not regarded as tax resident in Ireland under that tax treaty. Transitional provisions apply until 31 December 2020 for companies incorporated before 1 January 2015.

Foreign tax credits

A significant Irish development introduced in 2012 relates to the availability of additional notional foreign tax credits on certain foreign dividends. To be eligible for the additional credit, certain conditions must be met. In particular, the dividend must be paid by a company resident in an EU or EEA country with which Ireland has concluded a tax treaty.

In effect, the additional foreign tax credit provisions allow for increased double taxation relief on qualifying dividends. The credit provides relief by reference to the statutory or headline rate of corporation tax in the country from which the dividend is paid rather than the actual WHT suffered or foreign tax paid on the underlying profits out of which the dividend was paid.

The provisions should provide for additional relief in certain cases where the actual foreign tax paid is lower than the headline tax rate or even nil due to the availability of reliefs or the utilization of tax losses or other credits, such as R&D credits, in the country from which the dividend is paid.

The provisions allow for an additional credit against Irish tax on foreign dividends, which can be used in addition to the normal credit available as calculated using the normal foreign tax credit relief calculations, should the credit calculated under the existing rules not be sufficient to relieve Irish corporation tax arising on such dividends.

However, any excess credits calculated using these rules are not eligible for pooling or carry forward to future periods. In addition, the credit is only available once any credit calculated under the old rules has been fully utilized.

Real estate investment trusts

In 2013, a tax regime for real estate investment trusts (REIT) was introduced. On electing into this regime, a qualifying company meeting the conditions is not liable for corporate tax on income and capital gains arising from its property investment business. Investors may be subject to tax on income distributions or disposal of their investment in the REIT, depending on the tax rules of their country of residence. Dividend WHT applies on distributions from REITs, although treaty relief may be available for non-residents of Ireland. A company must meet various conditions to qualify as a REIT. For example, the company must be publicly listed, maintain certain ratios of income to financing cost and loan to value, and 75 percent of its assets and income must derive from its property rental business.

Asset purchase or share purchase

The following sections provide insight into the issues that should be considered by buyers and sellers when a purchase of either assets or shares is contemplated. The advantages and disadvantages of both alternatives are summarized at the end of this report.

Purchase of assets

A purchase of assets usually results in an increase in the base cost of those assets for both capital gains tax and capital allowance purposes. The buyer may be entitled to use the intellectual property amortization rules discussed earlier in this report. However, a sale of assets (as opposed to shares) may trigger a clawback of capital allowances on plant and industrial buildings, which can be avoided in some instances. Higher stamp duty costs are also likely to arise for the buyer. (Certain assets, such as intangibles, may be exempt from stamp duty; see transfer taxes below.)

Buyers may be reluctant to acquire shares, as opposed to acquiring assets and a business, from the seller because of the exposure they would assume to the existing liabilities of the company, not all of which may be certain and known.

A shareholder may have a different base cost for their shares than the company has with respect to its trade and undertaking. This may influence a seller's decision on whether to sell shares or have the company sell the business assets. Where a company sells a business, the shareholders may become liable for a second charge to capital gains tax, or charges to income tax, if they attempt to extract the sales proceeds from the company. For this reason, the sale of shares directly may be more attractive to a seller than the sale of the company's assets.

Purchase price

For tax purposes, it is necessary to apportion the total consideration among the assets acquired. It is generally advisable for the purchase agreement to specify the allocation. This is normally acceptable for tax purposes, provided it is commercially justifiable.

When a business is purchased for a single price that is not allocated by the purchase agreement to the individual assets, there are no statutory rules for the allocation. It is necessary to agree the apportionment of the price over the assets with the Revenue Commissioners, normally by reference to the assets' respective market values. The Revenue Commissioners have the power to apportion the sales proceeds of a building that has attracted capital allowances between that part relating to the expenditure that attracted the allowances and that part that did not. Usually, this does not significantly affect the apportionment of price between goodwill and other assets.

If consideration over 500,000 euros (EUR), or EUR1 million in the case of a 'house' as defined, is paid for certain assets, including Irish real estate and goodwill, the seller must provide a tax clearance certificate before paying the consideration. If not, the buyer is obliged to withhold 15 percent of the consideration to be paid.

Goodwill

Goodwill paid for a business as a going concern is neither deductible nor capable of being depreciated or amortized for Irish tax purposes unless the goodwill is directly attributable to qualifying intellectual property (as discussed earlier). Where the purchase price for a business (as opposed to shares) contains an element of goodwill, the buyer commonly seeks to arrange the purchase agreement so that the price is payable for the acquisition of tangible assets and qualifying intellectual property, thus reducing or eliminating the element of purchase price assignable to non-deductible goodwill. The Revenue Commissioners would normally accept this where commercially justifiable prices are assigned to the various assets.

While allocating the purchase price for a business primarily to assets other than goodwill may benefit the buyer, such allocation can have disadvantages for the seller. Such allocation may lead to a clawback (called a 'balancing charge') of capital allowances claimed previously, where a higher price is paid for plant and machinery or industrial buildings. There could be income tax implications where the price is allocated to trading stock, and capital gains tax implications may arise. The buyer must also consider the stamp duty implications, as stamp duty is payable by the buyer rather than the seller. In many instances, the seller may have a zero or very low base cost for capital gains tax purposes for goodwill; in this case, minimizing the amount of the consideration referable to goodwill could also benefit the seller.

Depreciation

Tax depreciation (known as 'capital allowances') is available as a deduction for expenditure incurred on plant and machinery used for the purpose of a trade, profession or leasing, and for industrial buildings and (for a limited period) for commercial buildings situated in certain areas that have been specially designated for urban renewal. With minor exceptions, capital allowances on plant and machinery are calculated on a straight-line basis at a rate of 12.5 percent per year. Industrial buildings are subject to a straight-line rate of 4 percent per year.

The provisions relating to the tax-deductibility of expenditure on qualifying intangible assets are outlined earlier in this report.

Tax attributes

Tax losses are not transferred to a buyer entity from a third party on an asset acquisition. They remain with the seller company.

Value added tax

Like other EU member states, Ireland operates a system of valued added tax (VAT) based on European VAT directives. The standard rate of VAT is currently 23 percent; lower rates of 9 percent and 13.5 percent apply in certain circumstances.

VAT does not apply on the sale of a business by one taxable person to another taxable person. Where the buyer is not a taxable person at the time of the sale but will be as a result of carrying on the business post acquisition, the Revenue Commissioners generally accept that the transfer is not liable to VAT.

The recoverability of VAT on transaction costs is a complex area, particularly as VAT does not apply to the related transaction. Early professional advice is recommended to minimize any irrecoverable VAT.

Transfer taxes

Stamp duty is chargeable on documents that transfer ownership of property, when the document is executed in Ireland or the document relates to property in Ireland or things to be done in Ireland. Many assets may be transferred without the use of a document (e.g. transfer by delivery of plant and machinery). Interests in land can only be transferred

by use of a document, and failure to stamp that document can have serious implications for title to the land. A company secretary cannot act on share transfer documents relating to shares in Irish companies unless they are stamped. Where shares in a company are issued for non-cash consideration, a return must be made to the companies registration office; this return attracts stamp duty even if the underlying assets were transferred by delivery rather than by means of a written document.

Generally, the rate of stamp duty for transfers of Irish shares and marketable securities is 1 percent. However, for certain share transfers executed on or after 6 December 2017, an increased rate of 6 percent has been introduced for shares in a company that derive their value, or the greater part of their value, directly or indirectly from Irish situated immovable property that is not residential property (subject to exceptions). The rate of stamp duty for transfers of non-residential property has increased to 6 percent (from 2 percent). The transfer of non-Irish shares and securities is normally exempt from Irish stamp duty.

There are exemptions from stamp duty, particularly in relation to the financial services industry and the transfer of certain intangible assets.

There are also reliefs from stamp duty (subject to conditions for certain group reconstructions and amalgamations) for transactions within a 90 percent worldwide group. A key condition for this relief to apply is that both parties remain 90 percent associated for a 2-year period after the transaction. A merger by absorption effected under the Companies Act 2014 would not meet this condition as the transferor is dissolved on the merger. A technical amendment introduced in 2017 allows such a merger qualify for the relief where the recipient retains the assets for 2 years following the transfer and the beneficial ownership of the recipient remains unchanged for that period.

In addition, the relief from stamp duty on transfers under a bona fide reconstruction or amalgamation has been revised to specifically include transfers to a limited company or designated activity company (DAC) under Companies Act 2014 (i.e. merger by acquisition, absorption or formation of a new company).

Purchase of shares

The purchase of a target company's shares does not result in an increase in the base cost of the company's assets. There is no deduction for the difference between underlying net asset values and consideration.

A sale of shares by an Irish holding company may be exempt from Irish capital gains tax, provided the conditions contained within the holding company participation exemption are satisfied. Thus, the availability of this exemption may influence a shareholder's decision on whether to sell shares or assets and whether the sale should be made by an individual shareholder directly or by a holding company owned by the shareholder.

In addition, provided it is not part of a tax avoidance arrangement, an exchange of shares for other shares does not usually give rise to Irish capital gains tax as the charge is deferred until the newly acquired shares are disposed of. For this treatment to apply, the company issuing the shares must control the target company or acquire control of it as a result of the exchange. Alternatively, the shares should be issued through a general offer made to members of the other company or any class of members, and the offer should be made in the first instance on such conditions that, if satisfied, the acquiring company would have control of the target company. This relief may make it attractive to shareholders in a target company to accept shares rather than cash for their shares. The standard rate of capital gains tax in Ireland is 33 percent.

Tax risks and exposures in a target company will transfer to a buyer following a share acquisition. In addition to the standard tax risk areas to be considered as part of due diligence, possible State Aid exposures should be considered in light of the European Commission's recent decision in the Apple State Aid case (which is under Appeal to the European Courts).

Tax indemnities and warranties

In the case of negotiated acquisitions, it is usual for the buyer to request and the seller to provide indemnities and warranties as to any undisclosed taxation liabilities of the target company. The extent of such indemnities or warranties is a matter for negotiation.

Tax losses

In principle, carried forward Irish tax losses generated by the target company transfer along with the company. However, losses arising before a change in ownership may no longer be available for carry forward against subsequent profits in the following circumstances:

— Within any period of 3 years, there is both a change in the ownership of a trading company and a major change in the nature or conduct of the company's trade.

— At any time after the level of activity in a company's trade has become small or negligible and before any considerable revival of the trade, there is a change in the company's ownership (this anti-avoidance measure aims to prevent 'loss buying' by companies).

Capital losses that accrue to a company before its acquisition cannot be used to relieve gains on pre-acquisition assets of the acquiring group.

Crystallization of tax charges

The buyer should satisfy itself that it is aware of all intragroup transfers of assets within 10 years before a transaction occurring. The sale of the target company could trigger a degrouping capital gains tax exit charge for the chargeable company, which is the company leaving the group and the company being acquired in most transactions. It is usual for the buyer to obtain an appropriate indemnity from the seller.

Pre-sale dividend

In certain circumstances, the seller may prefer to realize part of the value of its investment as income by means of a pre-sale dividend. The rationale is that the dividend may be subject to a low effective rate of Irish tax, but it reduces the proceeds of sale and thus the taxable capital gain on sale, which may be subject to a higher rate of tax. The position is not straightforward, however, due to anti-avoidance provisions, and each case must be examined on the basis of its facts.

Transfer taxes

Stamp duty is payable on transfers of shares in Irish companies. The normal rate of stamp duty for shares is 1 percent. However, stamp duty of 6 percent applies to shares in a company that derive their value (or great part of their value) directly or indirectly Irish situate non-residential property. As mentioned, relief is available (subject to conditions) on such stamp duty arising in share-for-share swaps and shares-for-undertaking swaps and also for certain intragroup transactions and mergers. Where the buyer undertakes to pay debt to the target company, separately from consideration payable for the shares, in certain cases, the amount of the debt repayable give rises to an additional 1 percent charge to stamp duty.

Tax clearances

It is not possible to obtain a full clearance from the Revenue Commissioners regarding the present and potential tax liabilities of a target company. The target company's tax advisers can usually obtain a statement of the company's tax liabilities as known at that point in time from the Revenue Commissioners. However, such a statement does not prevent the Revenue Commissioners from reviewing those liabilities and subsequently increasing them.

If the value of shares is mainly derived from Irish real estate and the purchase consideration exceeds EUR500,000 (or EUR1 million in the case of a 'house' as defined), the seller is obliged to furnish a capital gains tax clearance certificate to the buyer before the payment of consideration. If not, the buyer is obliged to withhold 15 percent of the consideration.

Choice of acquisition vehicle

The following vehicles may be used to acquire the shares or undertaking of the target company.

Irish holding company

An Irish holding company might be used if it is desired to obtain a tax deduction for interest on acquisition financing in Ireland or otherwise integrate the target into an Irish operating group.

Ireland also has two favorable attributes as a holding company regime, particularly as a European headquarters location:

— an exemption from capital gains tax for gains arising on the disposal of certain shares

— a form of onshore pooling, which does not exempt dividends from foreign subsidiaries from corporate tax but substantially reduces (or eliminates) Irish taxation attributable to foreign dividends.

The capital gains tax exemption exempts gains arising on the disposal of certain shares accruing to an Irish holding company. Capital losses arising on such shares are not deductible against other capital gains accruing to that company.

The conditions applying to the holding company are as follows:

— It must hold the shares in the investment and meet conditions discussed later in this report for an uninterrupted period of at least 12 months.

— The investor company must hold not less than 5 percent of the investee company's equity share capital.

— At the time of disposal, the business of the investee company must consist wholly or mainly of carrying on a trade or trades, or it must be part of a trading group whose business consists wholly or mainly of the carrying on of a trade or trades.

— At the time of disposal, the investee must be resident in the EU or a jurisdiction with which Ireland has a tax treaty.

— The investee must not derive the greater part from Irish real estate. An anti-avoidance measure was recently introduced to counteract certain planning transactions that would ensure this condition was met. Shares will continue to be treated as deriving their value from Irish real estate even where cash or other assets are transferred to the company before its disposal by a connected person to dilute its value derived from Irish land. This measure only applies if avoiding tax is the transaction's main purpose.

Taxation of inbound dividends

The onshore pooling of dividends affects the taxation of dividends received by a holding company from its offshore investees. Generally, foreign dividends received by a holding company from trading subsidiaries in EU or treaty countries are chargeable to tax at a rate of 12.5 percent. The rules extend the 12.5 percent rate to dividends from non-treaty,

non-EU locations where the paying company is a quoted (publicly listed) company, or is owned directly or indirectly by a quoted company. Otherwise, the dividends generally are taxable at a rate of 25 percent.

The onshore pooling regime allows an Irish company to aggregate all the credits on foreign dividends received for set-off against the Irish tax arising on these dividends. Excess tax credits can be carried forward for use in future tax years.

As noted, an additional credit for foreign taxes on foreign dividends was introduced in 2012, allowing for increased double taxation relief on qualifying dividends. Relief is provided by reference to the statutory or headline rate of corporation tax in the country from which the dividend is paid (rather than the actual WHT suffered or foreign tax paid on the profits giving rise to the dividend). However, excess credits are not eligible for pooling or carry forward to future periods. The credit is only available after the full utilization of any credit calculated using the original onshore pooling regime.

Foreign parent company

The foreign buyer may choose to make the acquisition itself, perhaps to shelter its own taxable profits with the financing costs. This would not necessarily cause any Irish tax problems, as Ireland does not tax the gains of non-residents disposing of Irish share investments unless the shares derive more than 50 percent of their value from assets related to Irish real estate.

Dividends and other distributions from Irish resident companies are subject to dividend WHT at the standard rate of income tax (currently 20 percent). There are numerous exemptions from dividend WHT, which generally depend on the recipient making written declarations to the paying company. Exemptions from dividend WHT are available in relation to dividends paid to Irish resident companies, companies resident in the EU or treaty states, companies ultimately controlled from the EU or treaty states, and certain quoted (publicly listed) companies.

Non-resident intermediate holding company

The analysis in 'Foreign parent company' above also applies non-resident intermediate holding companies. The payment of dividends to intermediate holding companies that are resident in tax haven jurisdictions can give rise to WHT.

However, depending on the residence of the ultimate parent company, it may be possible to take advantage of exemptions from dividend WHT.

Local branch

A branch of a non-resident company may qualify for the 12.5 percent rate of corporation tax (applicable to trading income). There are no Irish capital gains tax advantages to using a branch over a resident company structure. A sale of branch assets is subject to Irish capital gains tax. Capital gains tax only applies on a non-resident's sale of shares in an Irish company if the value of the shares is mainly derived from Irish real estate-type assets.

Some forms of tax relief depend on the use of a company based in the EU or a country with which Ireland has a tax treaty. Acquiring an undertaking through the branch of a foreign company offers certain advantages:

— Dividend WHT does not arise on the repatriation of branch earnings abroad. This is not a major advantage when the holding company is resident in or controlled from a treaty state because exemptions are generally available for Irish resident-paying companies.

— The repatriation of profits abroad other than by way of dividends may be important in the context of controlled foreign company (CFC) legislation in the investor's home country (e.g. US Subpart F rules).

Joint venture

Joint ventures can be either corporate (with the joint venture partners holding shares in an Irish company) or unincorporated (usually an Irish partnership). In practice, there may be non-tax reasons that lead a buyer to prefer using a corporate joint venture. Factors such as the availability of Irish tax deductions for acquisition financing or the differing tax attributes of investors (e.g. individuals versus corporations) might mean a corporate joint venture is substantially more favorable from a tax perspective.

Consortium loss provisions allow the surrender of losses to Irish corporate joint venture investors in certain cases where they might not have the 75 percent majority shareholding required to meet the normal tax loss group relief conditions.

Choice of acquisition funding

Where loans are required to finance the takeover, the structure used for the takeover may be influenced by the need to obtain tax relief (in Ireland, elsewhere or both) for interest on those loans. Ireland does not have specific thin capitalization rules (see 'Deductibility of interest' later in this report).

Debt

Interest is deductible for Irish corporation tax purposes in the following circumstances:

— It is incurred wholly or exclusively for the purposes of a trade.

— It is incurred on loans used to acquire, improve or maintain a rental property (in which case it is deductible only against the rental income and is subject to certain restrictions).

— It is annual interest paid on loans used to acquire a shareholding in an Irish rental income company, trading

company or the holding company of such companies, or in lending money to such companies, provided the company controls more than 5 percent of the target company, has a common director and meets all other relevant conditions for relief. Finance Act 2017 confirmed that tax relief is also available for interest on loans used to acquire indirect holding companies of trading companies where certain conditions are met.

Interest is deductible on an accruals basis in the first two circumstances above but only when paid in the third circumstance.

Deductibility of interest

Ireland does not have thin capitalization rules per se. However, certain aspects of the legislation treating interest as distributions (discussed earlier) have a similar effect in that interest on convertible loans (among others) may be regarded as a distribution.

The rules for the deductibility of interest are outlined earlier. Annual interest paid after deduction of tax (or paid gross where the legislation or a tax treaty provides, or in certain cases where the Revenue Commissioners have provided consent) is deductible for corporation tax purposes when the loan was used to acquire shares in or advance moneys to a trading or Irish rental income company or a holding company of such companies in which the investing company has a greater than 5 percent interest and a common director. The interest deductibility is restricted in certain instances for borrowings between connected companies. Subject to certain exceptions, relief is not available where intragroup borrowings are used to finance the intragroup acquisition of assets. Relief also is restricted in certain circumstances where the loan is used to fund foreign connected parties.

Where interest is set at a rate that is more than a reasonable rate of return on the loan in question, it may be regarded as a distribution and not as interest. No other transfer pricing rules apply specifically to interest.

WHT on debt and methods to reduce or eliminate it

Ireland imposes WHT on Irish source annual interest only (i.e. interest on a loan that can be outstanding for more than 1 year). Such interest must be paid after deduction of tax if paid by a company resident in the state or paid by any Irish-resident person to a non-resident person.

Exceptions are available where:

— interest is paid by and received by banks carrying on a bona fide banking business in the state

— interest is paid to or by a qualifying securitization vehicle

— the Revenue Commissioners approve making the payment gross

— interest is paid by a company in the ordinary course of a trade or business to a company resident in a treaty state or in the EU, provided the country in question imposes a tax that generally applies to foreign-source interest income receivable.

Interest WHT does not apply to interest that is treated as a distribution, as explained earlier. The rate of WHT on interest is the standard rate of income tax (currently 20 percent).

A tax treaty may eliminate the obligation to withhold tax or reduce the rate of WHT applicable to interest. However, where the treaty concerned merely reduces the rate of tax payable, payment may be made at the reduced rate of withholding only with the prior consent of the Revenue Commissioners. Without such consent, the payer should apply WHT and the recipient would seek a tax refund (where applicable) from the Revenue Commissioners.

Checklist for debt funding

— Ireland has no thin capitalization rules.

— Since many Irish companies pay tax at a rate of 12.5 percent, it is sometimes more beneficial to obtain tax relief for the loans in another jurisdiction, where the acquiring company also has taxable income, than it is to obtain such relief in Ireland. However, it is difficult to generalize in this area.

— The tax-deductibility of certain types of acquisition financing is subject to the satisfaction of detailed conditions, is only available on a paid basis (and not on an accruals basis), and can only be used to offset Irish group profits in the year of payment.

— Subject to treaty relief and certain domestic exemptions, WHT of 20 percent may apply on interest payments.

Equity

A buyer may use equity to fund its acquisition, possibly by issuing shares to the seller in satisfaction of the consideration or by raising funds through some form of placing. Further, the buyer may wish to capitalize the target post-acquisition. Ireland has no capital duty on the issue of shares.

However, as Ireland has no thin capitalization rules, the choice of equity as part of the funding does not tend to be driven by the buyer's Irish tax considerations. Seller financing often takes the form of equity so the seller can defer paying capital gains tax.

A key drawback of equity funding is that it offers less flexibility than debt should the parent subsequently wish to recover the funds. An Irish-incorporated company may buy back its own shares and cancel them, or, to a limited extent, hold them as treasury shares. It may convert ordinary share capital into redeemable share capital and then redeem it.

Previously, such buy-backs and redemptions of shares generally had to be effected from distributable profits or

with court approval. However, since 1 June 2015, an Irish incorporated private limited company is also permitted to buy back or redeem its own shares whether it has distributable reserves or not, provided the directors of the company provide a declaration confirming that the company will remain solvent and an auditor confirms in a report that this declaration is not unreasonable.

Under existing tax legislation, to the extent that shares are bought back or redeemed for an amount in excess of their issue price by an unquoted company, the excess is treated as a distribution. Share buy-backs and redemptions of shares by public companies are generally treated as capital gains tax transactions; these transactions are subject to anti-avoidance legislation and a requirement to notify the Revenue Commissioners of such a transaction occurring in a relevant accounting period.

An exception applies for the buy-back or redemption of shares in trading companies or holding companies of trading companies (in certain circumstances only and usually limited to minority shareholdings). Under this exception, the transaction is treated as being subject to capital gains tax rules rather than distribution rules. In some cases, it may be more tax-efficient for a seller to have their shares redeemed or bought back by the company in a manner that subjects the transaction to income tax, rather than to dispose of the same shares in a manner that attracts capital gains tax. Similarly, a dividend from a company before sale can be a tax-efficient method of extracting funds in some instances, although anti-avoidance legislation may apply. Where a company borrows money to fund a buy-back or redemption of its shares, the related interest may not be deductible, depending on the circumstances.

The payment of an intragroup dividend between Irish-resident companies generally has no tax implications (assuming the companies are not closely held). The exemption does not apply where the paying company has moved its tax residence to Ireland in the previous 10 years and the payment relates to profits earned when the company was non-Irish-resident.

It may be possible for overseas shareholders in Irish companies to receive dividends free of tax in their home country (and free of tax in Ireland), under either the domestic law of the shareholder's country (participation privilege-type exemptions) or a tax treaty.

Hybrids

The distinction between debt and share capital for tax purposes is based on the legal distinction involved. Only share capital that is in accordance with company law is share capital for tax purposes. Only a dividend that is a dividend for the purposes of company law is a dividend for tax purposes. However, interest on debt instruments may be treated as a distribution (akin to a dividend) in certain circumstances.

Interest is a distribution when it is paid with respect to a security:

- that is convertible into shares, provided the security is neither quoted (listed) on a recognized stock exchange nor issued on terms comparable with those so quoted
- the interest on which depends to any extent on the company's business results
- that is connected with shares in the company where, owing to the nature of the rights attaching to the securities or shares, it is necessary or advantageous for a person to hold a proportionate holding of each; the circumstances in which such interest is treated as a distribution are broader for interest paid to a non-resident than for interest paid to an Irish-resident company or a company trading in Ireland through a branch or agency
- where the interest gives more than a reasonable rate of return
- that is issued by the company and held by a company resident outside Ireland where:
  - the company that issued the security is a 75 percent subsidiary of the other company, or
  - both the issuing and recipient companies are 75 percent subsidiaries of a third company that is not resident in Ireland.

It is possible to mitigate the treatment of interest being treated as a distribution in the circumstances of the final scenario noted above where the interest is paid to a company that is resident in an EU member state or where the interest is trading interest and an election is made to opt out of the distribution treatment.

The interest is rarely treated as a distribution where it is payable to a company that is subject to corporation tax in Ireland in the case of:

- convertible securities
- securities whose interest varies with the company's results
- securities connected with shares in the company.

In these cases, interest is treated as a distribution only if certain additional conditions are met, so the provision does not apply in most such situations.

Share options are not treated as share capital for tax purposes. Options are subject to capital gains tax treatment, except for a dealer in shares or a financial institution. When exercised, the grant and acquisition of the option generally merge with the acquisition and disposal of the asset over which the option existed, except for a share dealer or financial institution.

Special rules are applicable to share options granted in the context of an office or employment. Employment-related share options are broadly subject to income tax rather than capital gains tax. However, the rules can vary depending on the nature of the scheme.

Discounted securities

The tax treatment of securities issued at a discount to third parties might follow the accounting treatment, enabling the issuer to obtain a tax deduction for the discount accruing over the security's life. However, there are some uncertainties surrounding the tax treatment of discounts (including WHT obligations, if any). Specific advice should be sought when contemplating the use of discounted securities.

Deferred settlement

Interest is not imputed on outstanding consideration for the disposal of shares. When no interest is payable or a rate of interest lower than market value is payable on the debentures or outstanding consideration transfer pricing rules do not apply to impose an interest charge.

In most instances, the date of disposal of an asset for capital gains tax purposes is the date on which the contract for the disposal of the shares becomes unconditional. For that reason, liability for capital gains tax can arise at a date in advance of the date of receipt of consideration. Although it is possible to defer payment of the capital gains tax, interest may arise. In certain circumstances, deferred consideration may be regarded as an asset in itself, constituting consideration for the disposal (at its discounted open market value at the date of the disposal). The final receipt of the consideration may then involve a disposal of the deemed asset consisting of the right to receive the consideration. The stamp duty implications of any deferred payment arrangement also should be considered.

Other considerations

Concerns of the seller

The principal concerns of a seller of a business or assets are likely to be:

— reducing any capital gains tax exposure

— minimizing the clawback of capital allowances on assets being sold.

Concerns that a seller may have in connection with a sale of shares are as follows:

— A sale of shares may be preferable to a sale of an undertaking because the gain may be exempt under the holding company regime mentioned earlier in this report.

— If not exempt under the holding company regime, only one charge to capital gains tax potentially arises before the seller has direct possession of the sales proceeds. When an undertaking owned by a company is sold, as opposed to a sale of shares, capital gains tax may arise both on the sale of the undertaking and later on the disposal of shares in the company when the shareholder attempts to realize the cash proceeds.

— The capital gains tax base cost of shares in a company may not be the same as the base cost of the company's undertaking and assets.

— The availability of capital gains tax losses for offset against taxable gains arising on the disposal may differ for the shareholder and the company. The availability of losses to one but not the other (arising out of previous transactions) might dictate a preference for the sale of the shares or the undertaking. Care should betaken in relation to anti-avoidance provisions regarding loss-buying by companies.

— Capital gains tax liabilities on a disposal of shares or an undertaking generally may be deferred if the consideration consists of other shares (subject to conditions).

— The seller would usually try to avoid a clawback of capital allowances on the disposal of assets.

— A clawback of inheritance tax or gift tax relief on shares in the company may occur if those shares are disposed of within 6 years of the date of a gift or inheritance.

— Non-Irish-resident sellers of shares are only subject to Irish capital gains tax on the sale of the shares if the shares derive the greater part of their value from Irish real estate-type assets (or certain other specified assets). Consequently, the above concerns might not be relevant for non-Irish sellers.

Stamp duty is not normally a concern of the seller other than in the context of an arrangement to avoid capital gains tax or the clawback of capital allowances. The effect of a change in ownership on trading losses carried forward from previous periods does not normally concern the seller, although it may be of concern to the buyer. The buyer, not the seller, may have concerns over the recognition of deferred capital gains tax on a company leaving a group, as discussed earlier, when the company owns assets obtained from other group companies on which capital gains tax was deferred at the time of transfer.

When the seller has been entitled to relief for interest on loans to finance their shareholdings, all or some of the relief would be lost on the sale of the shares. This relief is unlikely to be lost on the sale of an undertaking.

Company law and accounting

A merger usually involves the formation of a new holding company to acquire the shares of the parties to the merger. The merger generally is achieved by issuing shares in the new company to shareholders of the merging companies, who swap their shares in those companies for shares in the

new company. The new company may (but need not) have the old companies wound up and their assets distributed to the new company once the liabilities have been discharged or the creditors have agreed to the new company assuming the liabilities.

Since 1 June 2015, an Irish incorporated company may undertake a legal merger where one or more Irish incorporated companies dissolves and all of its assets and liabilities are transferred to another Irish incorporated company that may be either a new or an existing company. It is also possible for Irish incorporated companies to merge with other non-Irish EU incorporated companies pursuant to the EU cross-border merger regime.

A takeover may be achieved by the bidder offering cash, shares, loan notes or a mixture of all three in exchange for either the shares of the target company or its undertaking (broadly speaking, its business) or assets.

If the business and assets of the target entity are acquired as opposed to its shares, the buyer is obliged to take on the existing employees of the business pursuant to the European Commission (Protection of Employees on Transfer of Undertaking) Regulations 2003. The employees also have a general right to be informed and consulted about any substantial changes that directly affect them.

An amalgamation, such as a share-for-share exchange or share-for-undertaking exchange, is possible without court approval. In the case of a share-for-undertaking exchange, where the shares issued by the buyer are received directly by the shareholders in the target company, the target company must have sufficient distributable reserves to effect the transaction and the transaction must not involve a reduction in the company's share capital. However, where a compromise arrangement is proposed between a company and its creditors, an application to the court is necessary (section 455 CA 2014) in connection with a proposed reconstruction of a company or an amalgamation of two or more companies. The court may either sanction the reconstruction or amalgamation or make provisions for any matters it deems suitable (by order under section 455).

A proposed merger or takeover may require notification to the Competition and Consumer Protection Commission (CCPC) in writing within 1 month of a public offer that can actually be accepted. The authority must be notified where the following conditions are met in the most recent financial year:

— The aggregate turnover in Ireland of the undertakings involved (i.e. the buyer and the target on a group basis but not the seller) is not less than EUR50 million.

— Each of two or more of the undertakings involved carried on business in any part of Ireland.

— Each of at least two or more of the undertakings involved in the merger or acquisition have turnover in Ireland of at least EUR3 million.

The CCPC will determine whether, in its opinion, the result of the transaction would be substantially to lessen competition in any market in Ireland.

Company law and accounting standards predominantly determine the accounting treatment of a business combination. Generally, most combinations are accounted for as acquisitions, and merger accounting is only applied in limited circumstances. Merger accounting is not allowed under International Financial Reporting Standards; all business combinations must be accounted for as acquisitions. The relevant Irish accounting standards and company law restrict merger accounting to a very small number of genuine mergers and group reorganizations.

One of the main practical distinctions between acquisition accounting and merger accounting is that acquisition accounting may give rise to goodwill. The net assets acquired are brought onto the consolidated balance sheet at their fair values, and goodwill arises to the extent that the consideration given exceeds the aggregate of these values. Under Irish generally accepted accounting principles, the goodwill is then amortized through the profit and loss account over its useful economic life.

Acquisition accounting principles also apply to purchases of trade and assets, with any goodwill and fair value adjustments appearing on the buyer's own balance sheet. In merger accounting, goodwill does not arise because the buyer and the seller are treated as though they had operated in combination since incorporation; adjustments are made to the value of the acquired net assets only to the extent necessary to bring accounting policies into line.

Another important feature of Irish company law concerns the ability to pay dividends. Distributions of profit may be made only out of a company's distributable reserves. For groups, this means the reserves retained by the holding company (or its subsidiaries) rather than those of the consolidated group. Regardless of whether acquisition or merger accounting is adopted in the group accounts, the ability to distribute the pre-acquisition profits of the acquiring company may be restricted, although new relieving provisions in this regard were introduced on 1 June 2015.

Finally, a common issue on transaction structuring arises from the provisions concerning financial assistance. Broadly, these provisions say that it is illegal for a public company (or one of its private subsidiaries) to give financial assistance, directly or indirectly, for the purpose of acquiring that company's shares. Similar provisions apply to acquisitions of private companies unless a summary approval procedure is carried out whereby the directors to make statutory declarations about the company's solvency.

Group relief/consolidation

Tax relief for losses is available for groups of companies.

An EU-resident company and its EU-resident 75 percent-owned (or greater) subsidiaries can form a group for the purposes of surrendering losses between group members. Thus, Irish losses arising from trading (principally) in one company may be surrendered to another group member to offset Irish trading income arising in the same year and the previous year. Share-of-profits and share-of-assets tests must be met when determining whether one company is a 75 percent subsidiary of another.

A company may also surrender losses to members of a consortium owning the company. This relief is available where five or fewer EU-resident companies control 75 percent of the ordinary share capital of the surrendering company and all of the shareholders are companies. Other forms of loss relief for trading losses are available to reduce tax on non-trading income and gains subject to corporation tax on a group basis. Trading losses are relieved on a value basis against non-trading income of group companies, in a similar manner to that described earlier in this report.

Following the European Court of Justice (ECJ) judgment in *Marks & Spencer*, an Irish-resident company can now claim group relief from a surrendering company that is resident in an EU or EEA member state with which Ireland has a tax treaty. The surrendering company must be a direct or indirect 75 percent subsidiary of the claimant company. Group relief cannot be claimed by an Irish resident company in respect of losses of a foreign subsidiary that are available for offset against profits in another jurisdiction or that can be used at any time by way of offset against profits in the country in which the losses arose.

Transfer pricing

Ireland introduced a transfer pricing regime as of 1 January 2011. Before then, Ireland had no specific transfer pricing regime, although there was always a requirement for transactions to be entered into at arm's length. The current legislation covers domestic and international trading transactions entered into between associated companies. The regime applies to trading transactions only and requires specific covered transactions to be entered into at arm's length. The rules only apply to large enterprises that exceed certain employee, asset and turnover thresholds on a global basis.

Dual residency

Residence in Ireland for tax purposes can be based on either the registration of the company in Ireland or the location in Ireland of the central management and control of a company registered elsewhere. The general rule is that a company is tax resident in Ireland where it is incorporated in Ireland. When a tax treaty treats an Irish-registered company as resident in another state, it is not treated as resident in Ireland under Irish domestic law.

Irish companies incorporated before 1 January 2015 are generally not subject to the new tax residence rules until the end of 2020.

Residence in Ireland for tax purposes is also based on the location in Ireland of central management and control of the company's affairs. Thus, it is possible for a company that is managed and controlled in Ireland but registered in another jurisdiction to be dual resident if the other jurisdiction in which it is registered recognizes residency on the basis of place of registration. A company may also be dual resident if the company is Irish-incorporated but centrally managed and controlled in a jurisdiction that treats the company as being resident in that jurisdiction (subject to the exception noted earlier regarding residence under a tax treaty). There are no particular advantages from the viewpoint of Irish taxation in having dual residency.

Foreign investments of a local target company

Where the Irish target company holds overseas investments while resident in Ireland, it is liable to tax in Ireland on income from such investments and on gains on the disposal of those investments unless exemption is available under the holding company regime.

Comparison of asset and share purchases

Advantages of asset purchases

— A tax basis for assets acquired, such as trading stock, is available, which is deductible at 12.5 percent.

— Amortization or tax depreciation is tax-deductible for certain IP, plant and equipment and certain buildings.

— A market value tax basis can facilitate the extraction of valuable assets, such as IP, from the Irish tax net and thereby reduce the Irish tax base.

Disadvantages of asset purchases

— Irish VAT can arise (certain reliefs may be available to reduce the liability).

— Buyer usually pays higher stamp duty.

— No succession to accumulated losses forward.

— Practical issues such as potential need to renegotiate employment and supplier agreements.

Advantages of share purchases

— Buyer can inherit accumulated losses (subject to specific 'loss buying' anti-avoidance rules).

— Lower stamp duty of 1 percent (in most cases).

— No Irish VAT.

— Efficient for the seller.

Disadvantages of share purchases

— No step-up in basis in the underlying assets for the buyer.

— Potential clawback of tax reliefs claimed on previous intercompany transactions.

— Buyer inherits the tax history of the company, so full due diligence of the company's tax affairs is required.

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Italy

Introduction

Italy has no special tax regulations for mergers and acquisitions (M&A), which are principally governed by Presidential Decree no. 917/1986 (the Italian Consolidated Income Tax Code — ITC).

As a general rule, resident companies are subject to corporate income tax (*imposta sul reddito delle società* — IRES) and regional tax on productive activities (*imposta regionale sulle attività produttive* — IRAP). The basic IRES rate is 24 percent (down from 27.5 percent in fiscal year 2016). The basic IRAP rate is 3.9 percent, although IRAP rates vary according to the region where the company operates. Higher rates apply to banks, financial institutions and insurance companies, and to certain other industries.

This report describes the main tax issues to be considered when structuring a cross-border acquisition and is based on the tax rules applicable up to January 2018.

Accounting and legal issues are outside the scope of this report, but some of the key points to be considered when planning a transaction are summarized.

Recent developments

The following summary of Italian tax issues includes the amendments introduced by Law no. 205/2017 (2018 Budget Law). The most significant measures involve:

— step transactions for registration tax purposes

— extension of the step-up regime to equity interests held in foreign companies

— reduction in the interest expense deduction

— new taxation of dividends and capital gains on qualifying shares

— amendments to the taxation of dividends arising from a tax haven

— carried interest.

How these tax changes affect M&A deals is summarized in the following sections.

Asset purchase or share purchase

Generally, an acquisition may be structured as an asset deal or a share deal. The tax implications of these two structures are different.

Purchase of assets

In an asset purchase, a person buys a business[1] from another person for consideration.

Even if an appraisal of the business is not mandatory, it is often useful to have one in order to prove that the selling price is at arm's length and show how the purchase price is allocated.

The buyer may step up the tax basis of the assets to the price paid for them and then amortize and depreciate these assets based on their new tax basis.

From the seller's perspective, the sale of a business may give rise to a taxable capital gain or a deductible loss, which is the positive or negative difference, respectively, between the sale price and the tax basis of the business. The capital gain (or loss) is included in (or deducted from) the seller's overall IRES base in the year in which it is realized. The ordinary IRES rate (24 percent) applies. If the seller has held the business for more than 3 years, it may elect to spread the capital gain in equal installments over a period of up to 5 years. The capital gain or capital loss deriving from the sale of a business unit is not included in the IRAP base.

The buyer of a business is jointly and severally liable with the seller for any tax liabilities connected with the business and originating from any breaches of tax rules:

— committed in the year of acquisition or in the 2 previous years, or

— emerging from a tax audit that has taken place before the transaction.

The buyer's maximum liability is equal to the value of the business acquired. In order to limit the buyer's liability, both parties may apply for a certificate from the Italian tax authorities, attesting any tax debts existing on the acquisition date. The buyer's exposure can then be limited to the liabilities shown on the certificate. The buyer is not responsible for any

[1] Or a business unit — the rules on asset deals are the same for the acquisition of a business (azienda) and a business unit (ramo d'azienda).

tax liability of the seller if the Italian tax authorities do not issue the certificate within 40 days of the application or if no liabilities are indicated on the certificate.

Purchase price

There are no particular tax rules for allocating the purchase price to the individual assets and liabilities forming the business, so the purchase price should be allocated based on the fair market value of the assets and liabilities transferred. The buyer and the seller agree the overall consideration to be paid for the business. If they wish, they can then apportion the total consideration among the assets in order to identify, insofar as commercially justifiable, the price paid for any individual assets belonging to the business, including goodwill.

Goodwill

The portion of the consideration paid to acquire the goodwill of the business is recognized for tax purposes.

Goodwill may be amortized for IRES and IRAP purposes over 18 years; consequently, the deductible amortization allowance may not exceed one-eighteenth of its value per year.

Depreciation and amortization

Deductible amortization allowances may not exceed 50 percent of the cost per year in the case of copyrights, patents, methods, formulae and industrial, commercial or scientific know-how. In the case of trademarks, the annual amortization allowance may not exceed one-eighteenth of the cost.

Tangible assets may be depreciated from the tax year in which they are put into use, using the straight-line method.

Tax depreciation charges cannot be higher than the charges resulting from the application of the tax depreciation rates published in a Ministry of Finance decree. In the first tax year of use, these charges are halved.

These rules do not apply to assets worth less than 516.46 euros (EUR), because they can be fully depreciated in the tax year of acquisition.

The 2018 Budget Law extends the right to depreciate 130 percent (super-depreciation) and 250 percent (hyper-depreciation) of investments made in certain new tangible assets in 2018. The deadline for super-depreciation is extended to 30 June 2019, and for hyper-depreciation to 31 December 2019, if all the following requirements are met.

— By the end of 2018, the order has been accepted by the seller.

— At least 20 percent of the purchase price has been paid by 31 December 2018.

— The tangible assets are delivered before 30 June 2019 (super-depreciation) or 31 December 2019 (hyper-depreciation).

Tax attributes

Tax losses and other possible tax attributes are not transferred in an asset deal as they remain with the seller.

On certain conditions, value added tax (VAT) credits may be transferred to the buyer along with the business.

Value added tax

Business acquisitions are not subject to VAT. However, the sale of single assets by a VAT payer is generally subject to VAT at the ordinary rate of 22 percent (increasing to 24.2 percent in 2019, 24.9 percent in 2020, and 25 percent in 2021).

Registration taxes

According to the Registration Tax Code (RTC), the transfer of a business is subject to registration tax, generally paid by the buyer (although the parties may agree otherwise). However, both parties are jointly and severally liable for the payment of the registration tax.

The tax rate depends on the type of asset transferred:

— accounts receivable: 0.5 percent

— buildings: 9 percent

— land: 9 percent (15 percent for agricultural land)

— movable and intangible assets, including goodwill, patents and trademarks: 3 percent.

If the assets are subject to different registration tax rates, the liabilities of the business must be allocated to the different assets in proportion to their respective values. If the purchase price is not apportioned to the various assets, the registration tax is levied at the highest rate of those applicable to the assets (generally, the rates for buildings or land). Thus, it is recommended that the purchase price should be clearly allocated to each asset so that there is separate taxation based on the different tax rates.

The RTC provides that the tax basis of a business is its fair market value (not its purchase price, which may be different). The fair market value is subject to assessment by the registration tax office. Therefore, it is often advisable to obtain an appraisal from an independent expert in advance of the transaction.

Step transactions: new tax rules

When an asset deal is structured through the contribution of a business into a new company in exchange for shares in the new company, followed by the sale of those shares, it might be argued that only EUR200 registration tax is due on each transaction.

However, over the last few years, the Italian tax authorities have often treated such two-step transactions as a straightforward sale of business, subject to registration tax of 0.5 percent, 3 percent or 9 percent, depending on the type

of assets. The tax authorities argue that the anti-avoidance rule in article 20 of the RTC allows deeds to be defined by the economic purpose they achieve and by their interaction with other deeds executed immediately before or after.

Although several Supreme Court judgments have upheld this interpretation, it has attracted severe criticism from practitioners and academics.

The 2018 Budget Law redefines the scope of application of article 20 of the RTC, which now provides that the correct tax treatment depends on the nature of each single deed to be registered, regardless of any external interpretations or the scope of other transactions that might be linked to the one to be registered. This amendment took effect on 1 January 2018.

The 2018 Budget Law states that step transactions can be challenged only through the general anti-abuse rules, if applicable.

The impact of this change in law on existing litigation and past step transactions is uncertain.

Purchase of shares

No special issues arise for the buyer, except for the classification of the shares in the balance sheet (as inventory or fixed financial assets), which may affect the tax treatment of their subsequent sale.

In principle, the target company retains the tax attributes it had before the share acquisition; however, in certain cases, some of them may be jeopardized.

Tax indemnities and warranties

In a share deal, the buyer takes over the target company together with all its liabilities, including contingent liabilities. Therefore, the deal normally requires more extensive indemnities and warranties than an asset deal.

Tax losses and certain other tax attributes

A company cannot carry forward its available tax losses, interest expense and allowance for corporate equity (ACE) if it undergoes a change of control and its business activity also changes. This regime, aimed at tackling the abusive trading of tax attributes, does not apply if the following two conditions are met:

— The company employed a minimum of 10 employees throughout the 2 years preceding the year of the ownership change.

— The company's profit and loss account for the tax year preceding the year of the ownership change shows revenues (and other proceeds from the main activity) and labor costs (and related social security contributions) that are at least 40 percent of the average in the 2 preceding years.

If the above conditions are not met, the taxpayer may apply for a tax ruling to stop the rule's application.

Indirect taxes

Transactions involving shares, quotas, bonds and other securities are VAT-exempt.

Notarial deeds and private deeds with notarized signatures are subject to a fixed registration tax of EUR200 when they concern the trading of shares.

No stamp duty is applicable.

A financial transaction tax (FTT) is levied on transfers of shares (not quotas) issued by Italian companies. The FTT is due by the final buyer. The standard FTT rates are:

— 0.20 percent for over-the-counter transactions

— 0.10 percent for transactions executed on regulated markets.

Sales of shares between companies of the same group are normally not taxable for FTT purposes.

Share-for-share deal (contribution of a significant shareholding)

Article 177 (2) of the ITC establishes how to calculate capital gains when shares are contributed. For example, Company A contributes shares in Company C to Company B and Company B thereby acquires or increases (pursuant to an obligation imposed by law or articles of association) a controlling interest in Company C. In return for the contribution, Company A receives shares in Company B. To determine Company A's gain, reference must be made to the increase in Company B's equity as a result of the contribution. Company A's capital gain is the difference between:

— the equity increase of Company B, and

— the tax basis of the shares in Company A's accounts.

Step-up of values

Share deal

In a share deal, the acquired company's assets retain the same book value and tax basis as they had before the share acquisition. Thus, no step-up for tax purposes is usually allowed.

However, the tax basis of goodwill, trademarks and other intangible assets may be stepped up by levying a 16 percent substitute tax.

For stepped-up goodwill and trademarks, the minimum tax amortization period for the new higher book value is reduced to 5 years (from 18 years).

The 2018 Budget Law extends this rule to the acquisition of shares in non-Italian companies, for 2017 and later fiscal years.

Merger

It is possible to step up the tax basis of the target's underlying assets by merging the acquisition vehicle and target company after closing. In this case, the step-up of the tax basis of the

underlying assets is possible if the following substitute taxes are paid:

— 12 percent on the first EUR5 million of the higher amount

— 14 percent on the next part, up to EUR10 million

— 16 percent on the part exceeding EUR10 million.

Tax value of the shares to be sold

The 2018 Budget Law allows resident individuals and non-resident entities (having no permanent establishment in Italy) to step up the tax basis of their shares in unlisted resident entities if all the following conditions are met:

— the shares are owned from or after 1 January 2018

— an appraisal is finalized by an expert by 30 June 2018

— an 8 percent substitute tax on the value of the shares as at 1 January 2018 is paid.

Choice of acquisition vehicle

A foreign company that intends to acquire a business or shares in a company located in Italy may do so:

— directly from abroad

— through a vehicle incorporated in a third jurisdiction

— through an existing permanent establishment in Italy

— through an Italian resident subsidiary, newly incorporated or already existing.

Local holding company

The most common forms of company in Italy are limited liability companies (Srl) and joint-stock companies (SpA).

If the asset is acquired through an Italian subsidiary (newly incorporated or already existing), repatriation of profits is subject to the domestic withholding tax (WHT) on dividends, unless the requirements for the EU Parent-Subsidiary Directive exemption are met or a lower (or nil) treaty rate applies. If a tax treaty applies, any subsequent disposal of the shares in the Italian subsidiary is not generally taxed in Italy.

Typically, an Italian holding company is used where the buyer wishes to offset the interest expenses against the target's taxable profits through a tax consolidation or merger, in accordance with the earnings-stripping rules.

Foreign parent company

Tax treatment of capital gains

A foreign buyer may choose to make the acquisition itself, perhaps to shelter its own taxable profits with the financing costs.

Under the tax rules in force up to and including 2018, if a non-resident company realizes a capital gain on the sale of a qualifying[2] equity interest in an Italian resident company and does not have a permanent establishment in Italy, IRES is payable as follows:

— for gains realized on or before 31 December 2017, 49.72 percent is taxable at a 24 percent rate of corporate income tax (CIT), with an effective tax rate (ETR) of 11.93 percent

— for gains realized on or after 1 January 2018, 58.14 percent is taxable at the CIT rate of 24 percent, with an ETR of 13.95 percent.

The 2018 Budget Law replaces the above system of taxation, from 1 January 2019, with a flat 26 percent substitute tax, aligned with the capital gains tax on non-qualifying shares.

On the disposal of a non-qualifying equity interest in an Italian resident company, gains realized by a non-resident seller (with no permanent establishment in Italy) are exempt in Italy if the shares are listed on a regulated market or the seller is resident in a state that allows an adequate exchange of information with Italy. In other cases, these capital gains may be taxed at 26 percent, unless they are exempt under a tax treaty.

Tax treatment of dividends

Dividends paid to non-resident shareholders are generally subject to a final withholding tax of 26 percent.

A reduced 1.2 percent withholding tax is levied if the beneficial owner is a company resident and subject to tax in an European Economic Area (EEA) member state that allows an adequate exchange of information with Italy.

Dividends paid to qualifying EU parent companies are not subject to withholding tax. To qualify, the parent company must:

— be resident for tax purposes in an EU member state

— have one of the eligible legal forms

— be subject to tax, and

— hold at least 10 percent of the capital of the subsidiary for at least 1 year without interruption.

Under an agreement between the EU and Switzerland, dividends paid to Swiss parent companies may be exempt from withholding tax under conditions similar to those in the Parent-Subsidiary Directive.

Local branch

The target company (assets or shares) can also be acquired through a permanent establishment of a foreign company. Under Italian law, a foreign company may establish a branch (permanent establishment) in Italy. However, branches cannot be considered as autonomous legal entities. From a corporate tax perspective, branches of non-resident companies are normally treated as resident corporations and taxed on their local profit.

[2] Qualifying shares in unlisted companies represent more than 20 percent of the voting rights or 25 percent of the stated capital. Qualifying shares in listed companies represent more than 2 percent of the voting rights or 5 percent of the stated capital.

Italy's definition of permanent establishment largely follows the definition in the Organisation for Economic Co-operation and Development's (OECD) model tax treaty.

Choice of acquisition funding

A buyer using an Italian acquisition vehicle needs to consider whether to use debt and/or equity.

Debt

The principal advantage of debt is the potential deductibility of interest, as dividend payments cannot be deducted for tax purposes. Another potential advantage is the deductibility of expenses, such as guarantee fees, when computing income for tax purposes.

In a leveraged buyout (LBO) involving a merger or tax consolidation with the target, companies may offset interest against income of the target, within the limits described below (see 'Deductibility of interest').

The Italian tax authority used to challenge some LBO transactions aggressively, mainly when the acquisition was made by a foreign entity.

On 30 March 2016, the tax authority clarified the tax treatment of LBOs via Circular 6 as follows:

— an LBO is not generally a tax-abusive transaction, so related interest expenses are deductible under the ordinary rules

— the tax authority will focus on the substance and activity of foreign inbound-investment platforms or holdings

— abusive transactions are still subject to review by the tax authority, based on the general anti avoidance rules.

Deductibility of interest

Interest expenses are fully deductible, to an amount equal to the interest income accrued in the same tax period. Any surplus is deductible to the extent of 30 percent of gross operating income (roughly, earnings before income taxes, depreciation and amortization — EBITDA).

Any interest expenses exceeding 30 percent of EBITDA may be carried forward for deduction in subsequent tax periods, to the extent that the net interest expenses (i.e. those exceeding interest income) accrued in future tax periods are less than 30 percent of each period's EBITDA.

The portion of EBITDA not offset against interest expenses, and financial charges pertaining to a period, may be added to the EBITDA of subsequent tax periods.

The 2018 Budget Law abrogates the provision in article 96 of the ITC that allows gross operating profit (ROL) to be increased by an amount equal to the dividends distributed by non-resident subsidiaries. This amendment is effective for 2017 and later fiscal years.

Where a company is part of a domestic tax consolidation arrangement, any non-deductible interest expenses (i.e. the portion exceeding 30 percent of EBITDA) may be used to offset the taxable income of another company within the tax group, if that company's own EBITDA has not been fully offset against its own interest expenses.

The above limits do not apply to the deductibility of interest expenses incurred by:

— certain financial institutions and holding companies of certain financial groups

— insurance companies and holding companies of insurance groups

— certain consortia and SPVs involved in public works.

Insurance companies, holding companies of insurance groups and qualifying asset management companies can deduct only 96 percent of interest.

Withholding tax on interest

A withholding tax (WHT) of 26 percent is applied to interest payments made to non-resident companies, unless a reduced treaty rate or an exemption is available.

No WHT is due on interest payments made by Italian companies to Italian banks.

A WHT exemption on interest payments may apply if the following conditions are met:

— the loan is a medium- or long-term loan (i.e. more than 18 months)

— the borrower is an enterprise

— the lender is a bank established in the EU, an entity listed in article 2 (5) (4–23) of the EU Capital Requirements Directive (2013/36/EU), an EU insurance company, or a foreign institutional investor subject to regulatory supervision in the country where it is established.

The EU Interest and Royalties Directive exemption may also apply if the following conditions are met:

— the company making the payment and the company receiving the payment are associated, as per the wording of the Directive

— the equity interests have been held for an uninterrupted period of at least 1 year

— the companies making and receiving the payments have certain legal forms

— the interest income is subject to tax.

Withholding tax generally does not apply to corporate bonds listed on a regulated market or multilateral trading facility in a country that allows an adequate exchange of information.

Equity

A buyer may use equity to fund an acquisition. Contributions in cash do not give rise to taxable income for the recipient company.

Cash and contributions in kind to the capital of resident companies are subject to a fixed registration tax of EUR200. Registration, mortgage and cadastral taxes are due on contributions of real estate.

Under domestic law, there is a 26 percent WHT rate on dividends paid by Italian companies to foreign companies.

The ordinary WHT rate is reduced to 1.2 percent (1.375 percent before 2017) if the recipient of the dividend is a company resident within the EU or EEA.

If the EU Parent-Subsidiary Directive requirements are met (e.g. the EU parent company holds at least 10 percent of the shares for more than 1 year, is subject to tax and is the beneficial owner of the dividend income), there is no WHT on dividend payments.

Deductibility of the notional cost of equity

Since 2011, Italian companies have been able to benefit from an additional deduction from their tax base: the allowance for corporate equity (ACE). The allowance is equal to the aggregate qualifying equity increase since fiscal year 2010, multiplied by a notional rate of return. The equity increases include those resulting from certain cash contributions, waivers of certain financial receivables owed by an Italian company to its shareholders, and undistributed profits set aside to freely disposable reserves.

The equity increases must be net of decreases resulting from distributions or assignments to shareholders and certain decreases that have to be made for anti-avoidance purposes.

The allowance is deducted from the company's net taxable income and, if it exceeds the company's net taxable income, the surplus can be carried forward indefinitely.

The ACE rates, set at 4.5 percent for 2015 and 4.75 percent for 2016, were reduced to 1.6 percent for 2017 and 1.5 percent for 2018 and later years.

Dividends not deductible for Italian tax purposes

Dividends paid by Italian companies to their shareholders may not be deducted from the IRES base.

Although equity offers less flexibility if the parent subsequently wishes to recover the funds it has injected, the use of equity may be more appropriate than debt in certain circumstances, such as the following:

— the target is loss-making, and it may not be possible to obtain immediate tax relief for interest payments

— an appropriate mix of debt and equity is required in order to have efficient interest deductions under earnings-stripping rules

— there are non-tax reasons for preferring equity, e.g. a higher level of equity may be preferable for commercial reasons.

Mergers, demergers and contributions of business units are usually tax-neutral transactions that do not trigger corporate income tax for companies or their shareholders.

Other considerations

Concerns of the seller

The tax position of the seller can have a significant influence on any transaction. If the seller of shares is an Italian company and if the shares are booked as inventory, any gain from the disposal of the shares must be included in full in the taxable income of the seller and taxed at the ordinary 24 percent IRES rate, as it is treated as revenue and not as a capital gain.

If the shares are booked as fixed financial assets in the financial statements (and have been since the fiscal year in which the shares were bought), any capital gain realized by the seller is 95 percent tax-exempt (participation exemption) if the shares:

— have been held continuously for at least 12 months

— are in subsidiaries that engage in an actual business activity.

These requirements must be satisfied from the first day of the third fiscal year preceding the year in which the shares are sold. Real estate companies are excluded from this regime if more than 50 percent of their aggregate asset value is represented by real estate other than assets built or purchased by the same company for resale or used in the business activity.

Conversely, capital losses on the disposal of shares that qualify for the participation exemption are not deductible by a corporate seller.

According to the Italian tax authorities, even if all the pre-conditions for the participation exemption are met, the regime does not apply to shares transferred in the context of a business transfer because the assets and liabilities included in that business must be considered as a 'whole' and cannot be unbundled (Circular 6/E of 13 February 2006).

Company law and accounting

M&A deals usually include transactions such as mergers, demergers and contributions in kind.

According to the Italian Civil Code, a merger involves the absorption of one or more companies by another company, resulting in the termination (without liquidation) of the absorbed companies and the transfer of their assets and liabilities to the absorbing company.

There are two types of mergers in Italy.

— All the companies are absorbed and their assets and liabilities are contributed to a newly incorporated

company (*fusione propria*). The shareholders of the absorbed companies receive shares in the new company in exchange for their shares in the absorbed companies.

— An existing company absorbs one or more companies (*fusione per incorporazione*). The shareholders of the absorbed companies receive new shares from the absorbing company.

In the demerger of a company, all or some of its businesses are contributed to one or more other companies. The beneficiary companies may be newly incorporated or they may already exist.

The shareholders of the demerged company receive new shares issued by the companies to which the assets and liabilities are contributed.

In a contribution in kind (e.g. contribution of business units or shareholdings), a company transfers assets to another company and receives shares issued by the recipient in return.

As a rule, a sworn appraisal by a court-appointed expert is a prerequisite for contributions of business units (for limited liability companies, the contributing company can appoint the expert). The appraisal should describe the contributed assets and liabilities, the value assigned to each item and the criteria used for the appraisal. A notary public must execute the contribution deed.

Under Italian generally accepted accounting principles (GAAP), the above three transactions are normally recorded at book value without any step-up.

When preparing their financial statements, Italian companies should generally use Italian GAAP, as set out in the Italian Civil Code and interpreted by the Italian Accounting Organization (OIC). Italian companies may in most cases also adopt International Financial Reporting Standards (IFRS) to prepare their accounts. These accounting standards provide for a step-up of the book values of the assets involved in a business combination, where certain conditions are met.

Finally, a common issue in transaction structuring is financial assistance. Broadly speaking, it is illegal for a company (or one of its subsidiaries) to give financial assistance, directly or indirectly, for the acquisition of that company's shares. Therefore, it is necessary to evaluate the rules carefully when structuring the financing of the deal and its security package.

Group relief/consolidation

As a general rule, Italian groups can opt for a domestic tax consolidation regime if the Italian companies are controlled by an Italian company.

However, a non-resident company can be head of the tax group if both the following conditions are met:

— the company is resident in a tax-treaty country

— it carries on a business activity in Italy through a permanent establishment.

The main advantage of tax consolidation is that 100 percent of the tax losses incurred by one or more companies of the tax group can be immediately offset against the taxable income of other group companies. Any consolidated tax losses can be used to offset up to 80 percent of consolidated taxable income in subsequent years. However, losses incurred before the start of the consolidation regime cannot be offset against the taxable income of other group companies. These tax loss carryforwards can only be offset against the taxable income of the company that incurred them.

Another advantage of tax consolidation is that the portion of interest expenses exceeding 30 percent of EBITDA (see 'Deductibility of interest' above) and generated after a company's inclusion in the tax group can be used to offset the taxable income of another group company, if certain conditions are met.

To join a tax group, a subsidiary must have been directly or indirectly controlled by the parent company since the beginning of the financial year in which the option for tax consolidation is exercised (control requirement). As group membership is optional, it is possible that not all the Italian subsidiaries potentially qualifying for tax consolidation will join the group.

The domestic tax consolidation regime is irrevocable for a period of 3 years, and there are specific rules on its termination. For example, it is terminated if the control requirement is no longer met or there are certain merger/demerger transactions during the 3-year period.

Each consolidated company is liable for any tax liabilities, penalties and interest assessed by the tax authorities on its income. However, the controlling company is liable not only for its own tax liabilities but also — jointly and severally — for the tax liabilities, penalties and interest of each of the consolidated companies.

A non-resident company that (i) has a certain legal form, (ii) has no permanent establishment in Italy, and (iii) is resident in an EU or EEA member state with which Italy has a tax information exchange agreement may also appoint an Italian resident company (or a permanent establishment) to opt for the domestic tax consolidation regime together with each resident company or permanent establishment that has the same non-resident parent company.

Transfer pricing

Transactions between resident companies and non-resident companies must be valued at fair market value if doing so increases the taxable base of an Italian company and if the non-resident:

— is controlled (directly or indirectly) by the resident

— controls (directly or indirectly) the resident, or

— is controlled (directly or indirectly) by the same person that controls the resident.

The fair market value is basically the arm's length price under the criterion used in the OECD transfer pricing guidelines. In other words, the price of each intercompany transaction, if it implies an increase in the tax base, should be equal to the consideration that would have been paid for goods and services of the same or similar type, in free market conditions, at the same stage in the distribution chain, and at the same time and place as the goods and services in question (or, if no such criterion is available, at the nearest time and place).

Since 2010, a group can prepare documentation supporting its transfer pricing (this is not mandatory). If such documentation is prepared and complies with the standards set by the Italian tax authorities, then a penalty-protection system applies and the group would not be subject to penalties if a tax assessment results in a transfer pricing adjustment.

If the documentation does not comply with the Italian tax authority's guidelines or is deemed incomplete, administrative penalties ranging from 90 to 180 percent of the maximum tax assessed would be imposed for any transfer pricing adjustment.

As of 2016, multinational enterprises that meet specific requirements are required to file a country-by-country (CbyC) report, which must include their by-country revenues, gross profit, paid and accrued taxes, and additional indicators of actual economic activities.

The CbyC report must be filed within 12 months of the group's year-end.

The Italian tax authority officially postponed the filing deadline for the first year of application (2016) to 9 February 2018.

Foreign investments of a local company

The controlled foreign company (CFC) rule provides that the profits realized by a non-resident company are considered as profits of an Italian resident person if:

— the resident person directly or indirectly controls the non-resident company

— the company is resident in a jurisdiction that is deemed to have a low-tax regime.

As of 2016, foreign tax jurisdictions can qualify as low-tax regimes if their nominal level of taxation (tax rate) is lower than 50 percent of the combined IRES rate and IRAP standard 3.9 percent rate.

However, the CFC rule does not apply to controlled companies established in an EU member state or in an EEA state that allows for an effective exchange of information with Italy (i.e. Norway and Iceland).

To avoid the CFC rule, an Italian resident taxpayer must prove that:

— the CFC truly trades on the market of the country or territory in which it is located (the 'business test'), or

— at least 75 percent of the CFC's income is subject to tax in a country whose nominal level of taxation is equal to or higher than 50 percent of the corporate tax rate in Italy (the 'subject-to-tax test').

The CFC rule also applies to controlled companies resident or established in an EU member state, Norway or Iceland when both of the following conditions are met.

— Certain income, such as interest, dividends, royalties or revenues from intercompany services, exceeds 50 percent of their total income.

— The effective tax rate is lower than 50 percent of the rate that would apply if the company were resident in Italy.

CFC income is taxed at the level of the Italian resident corporate shareholder at the standard CIT rate of 24 percent.

The 2018 Budget Law amends the tax treatment of dividends paid, directly or indirectly, by a CFC that passes the business test. The new law provides that 50 percent of such dividends are excluded from the taxable income of the Italian resident corporate shareholder (before this amendment, 100 percent of dividends were taxable).

Under certain conditions, the Italian resident shareholder may benefit from a foreign tax credit for income taxes paid by the CFC.

Anti-avoidance rules

A transaction may constitute abuse of law if it has no economic substance and is essentially aimed at obtaining undue tax savings. Even if it is formally compliant with Italian tax law, a transaction will be abusive if it is at odds with the purposes of the provisions and/or the principles of the Italian tax system.

A transaction has no economic substance if it involves facts, acts and agreements (even interconnected ones) that have no significant effects other than tax savings or, in general, tax advantages. Transactions cannot be defined as abusive if they are justified by sound business reasons; these reasons include shake-ups or management decisions to improve the structure or operations of a business.

The taxpayer is allowed to submit an application for a tax ruling on whether a transaction constitutes unfair tax behavior.

Dormant company rule

A company is deemed to be dormant if, in a fiscal year, its revenues are lower than the sum of the following items:

— 2 percent of the average tax basis of the company's financial assets in the fiscal year and the previous 2 years

— 6 percent of the average tax basis of the company's real estate assets in the fiscal year and the previous 2 years

— 15 percent of the average tax basis of the company's remaining assets in the fiscal year and the previous 2 years.

If the vitality test is not passed, the company's minimum taxable income is deemed to be the sum of certain specific items. A dormant company may carry forward its tax losses but it can only offset them against the portion of its income that exceeds the minimum taxable income.

If a company is considered as dormant, a higher IRES rate of 34.5 percent is applied to a notional income computed on the basis of the assets recorded in the company's balance sheet. In a tax group, the notional income cannot be offset against losses of other group companies.

A calculation similar to the vitality test is used for IRAP purposes. Other limits also apply for VAT purposes.

An entity is also considered as dormant in a fiscal year if it has had tax losses in 5 consecutive previous years

Certain exemptions may apply.

Companies are allowed to apply for a tax ruling and to give evidence of the circumstances that have prevented them from passing the vitality test.

Carried interest

In 2017, measures were introduced to define the Italian taxation of carried interest, which is a form of remuneration granted to managers and employees who hold shares, quotas or financial instruments with 'strengthened' economic rights.

Carried interest is granted to managers and employees of investment companies and private equity firms in order to align their interests with those of other investors.

The new tax rule treats carried interest as capital income rather than employment income if the following requirements are met:

— All the individuals who have a carried interest must have invested, in aggregate, at least 1 percent of the total amount invested.

— Income from the securities carrying special profit rights must accrue only after all the other investors have obtained a minimum pre-defined return on their capital investment.

— The securities must be held by the individuals for a minimum of 5 years, or less if another firm takes over the companies in which the individual's employer has invested or the funds in which the employer has invested are transferred to a new fund manager (change of control).

Comparison of asset and share purchases

Advantages of an asset purchase

— Step-up in the tax basis of the assets allows higher depreciation/amortization (including goodwill).

— Previous tax liabilities of the seller are only partially transferred to the buyer; in certain cases, they may be fully eliminated.

— Possible to acquire only part of a business.

— Possible for the seller to shelter the capital gain against any tax loss carryforwards of its own.

Disadvantages of an asset purchase

— Possibly unattractive to the seller, especially if a share sale would be partially exempt.

— May result in higher registration tax.

— Higher corporate income tax on capital gains.

— Benefit of any residual losses incurred by the target company remains with the seller.

Advantages of a share purchase

— Likely to be more attractive to the seller from a tax perspective (because the disposal may be partially exempt).

— Buyer may benefit from the tax losses of the target company.

— May have lower registration tax.

Disadvantages of a share purchase

— Buyer becomes liable for any claims or previous liabilities of the entity.

— No free step-up in the tax basis of the purchased assets.

KPMG in Italy

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Jersey

Introduction

Jersey is a dependency of the British Crown and benefits from close ties to Europe and especially the United Kingdom, being in the same time zone and having a similar regulatory environment and business culture. With its long tradition of political and economic stability, low-tax regime and economy dominated by financial institutions, Jersey is an attractive location for investment.

The island was placed on the Organisation for Economic Co-operation and Development (OECD) white list in April 2009 and thereafter has since scored highly on tax transparency, rated as 'compliant' by the OECD's Global Forum Assessment as of November 2017. Jersey is an early adopter of the OECD Standard for Automatic Exchange of Financial Account Information in Tax Matters and has also signed the Multilateral Convention on Mutual Administrative Assistance in Tax Matters.

As an associate member of the OECD Base Erosion and Profit Shifting (BEPS) project, Jersey has committed to implementing the four minimum standards. Legislation has been introduced to enable country-by-country reporting for accounting periods beginning on or after 1 January 2016 for purposes of improving tax transparency. Jersey also completed its internal legal processes to ratify the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI) on 24 November 2017 and was the third country to ratify the MLI in December 2017. Also in December 2017, the island committed by 2018 to address the European Union's (EU) concerns relating to economic substance under the EU Council's conclusions on an external taxation strategy.

Jersey offers no investment incentives other than its low-tax regime and does not provide any grants, subsidies or funds for foreign investors.

Jersey's corporate tax system is based on the 'zero/ten' concept. The general rate of corporate income tax is 0 percent. The rate of corporate income tax for certain companies with permanent establishments in Jersey and regulated by the Financial Services Commission is 10 percent. The rate of tax is 20 percent for utility companies and companies that receive rental income or property development profits from properties in Jersey.

Recent developments

Automatic exchange of information

Jersey has committed to support the efforts of the OECD to improve global tax transparency and combat aggressive tax avoidance and tax evasion.

On 13 December 2013, Jersey and the United States signed an intergovernmental agreement (IGA) to improve international tax compliance and to implement the US Foreign Accounts Tax Compliance Act (FATCA). Under the agreement, Jersey financial institutions (FI) are required to report certain account information to the Controller of Taxes in respect of specified US persons holding reportable accounts with the FI. The information is then forwarded onto the US Internal Revenue Service (IRS). Under the Jersey-US IGA, the 30 percent withholding tax and account closure requirements of FATCA do not apply, except in circumstances of unresolved, significant non-compliance.

Jersey adopted the common reporting standard (CRS) — the global standard for automatic exchange of information developed by the OECD — by implementing Taxation (Implementation) (International Tax Compliance) (Common Reporting Standard) (Jersey) Regulations 2015 on 24 December 2015, which took effect as of 1 January 2016. Jersey reporting financial institutions are obliged to identify, review and report on accounts that are maintained by them and held by residents for tax purposes (whether individuals or entities) of other jurisdictions. The first reports for the reporting year 2017 were submitted to the Comptroller of Taxes by 30 June 2017 for onward submission to other reportable jurisdictions.

As part of its commitments as a BEPS associate member, Jersey also began the spontaneous exchange of specific tax rulings with tax authorities of other jurisdictions affected by the rulings. The first set of rulings were exchanged in 2017.

Country-by-country reporting

As noted, Jersey has committed to support the actions under the OECD BEPS project, including the introduction of country-by-country reporting to improve transparency between multinational enterprises and tax authorities. The States of Jersey enacted the Taxation (Implementation) (International Tax Compliance) (Country-by-Country Reporting: BEPS) (Jersey) Regulations 2016, which took effect as of 21 December 2016. The regulations apply from the year 1 January 2016 and require certain multinational enterprises with parents resident in Jersey to report annually to the Comptroller of Taxes the details of revenue, profit, taxes and other measures of economic activity for each tax jurisdiction in which they carry out business. The regulations also require certain Jersey entities to file local country-by-country reports and further imposes a notification obligation on Jersey constituent entities.

Asset purchase or share purchase

A purchase of shares is the most common form of acquisition in Jersey because there is no capital gains tax in Jersey on the disposal of shares. From a tax perspective, there are no capital gains consequences to a company on the disposal of its assets. However, the potential recapture of capital allowances and taxation on the extraction of sales proceeds might make an asset acquisition less attractive to the seller. Since most companies pay tax at 0 percent, this may not be relevant in every case.

Purchase of assets

The purchase of assets may give rise to an increase in the base cost of those assets for capital allowances purposes. This increase is likely to affect the seller because a recapture of prior allowances is applied. Since there is no capital gains tax in Jersey, the seller can dispose of inherent goodwill without direct tax consequences, although the buyer would not receive any tax relief for purchased goodwill. Additionally, historical tax liabilities generally remain with the company and are not transferred with the assets.

Purchase price

For tax purposes, the consideration paid is apportioned on a reasonable basis between the assets acquired. The purchase agreement should specify the allocation, which is normally acceptable for tax purposes, provided there is a commercial rationale behind the apportionment. No specific statutory rules affect how the purchase consideration is allocated. However, in accordance with generally accepted accounting principles (GAAP), stock would normally be valued at the lower of cost and market value. Jersey does not have its own GAAP regulations, so companies can choose to report under other GAAP regulations, such as those of the UK and the US.

Goodwill

Any goodwill generated on acquisition is held on the balance sheet as an asset. No tax relief is available for the subsequent amortization of the asset to the income and expenditure account.

Depreciation

For tax purposes, no deduction for depreciation charges is allowed. Instead, tax relief is given for the cost of plant and machinery used in the provision of the trade at a specified rate by means of capital allowances. Expenditure on and disposal receipts arising from plant and machinery are pooled, and a capital allowance of 25 percent per year is applied on a declining-balance basis against taxable profits. A special allowance rate of 10 percent per year is allowed for horticultural greenhouses. Capital allowances are not available for expenditure on premises, such as industrial buildings, shops, hotels and offices.

Tax attributes

Tax losses and capital allowance pools in the target company remain with the company or are extinguished. They can only be used to relieve profits of the trade of the target company after the transaction. They cannot be transferred to the buyer.

Goods and services tax

In 2008, Jersey introduced a goods and services tax (GST) regime, which is similar to the UK's value added tax system and could apply to a transfer of trade and assets. GST applies at the standard 5 percent rate and must be charged on the supply of goods and services in Jersey that relate to a trade carried on by a taxable person. Some types of supply, such as housing and medical prescriptions, have a GST rate of 0 percent. Others, including certain financial services, postal services and medical supplies, are exempt.

The sale of assets of a GST-registerable business is subject to GST at the standard rate. However, the transfer of a business as a going concern is outside the scope of the charge to GST, provided (among other things):

— there is no significant break in trading

— the assets are used by the buyer with the intention of carrying on the same or similar business as the seller

— the assets are sold as part of the transfer of a business as a going concern.

No specified quantum of assets must be sold to meet the going concern standard.

Certain types of businesses in Jersey's finance sector can apply for international service entity status, which puts them outside the scope of GST. Companies that hold licenses to carry on business as deposit takers or trust or fund services businesses are automatically entitled to this status on payment of an annual fee.

Transfer taxes

Stamp duty of 0.5 percent is payable on Jersey land transactions (including residential and commercial property) up to the value of 50,000 British pounds (GBP). For land transactions of more than GBP50,000, scale rates apply up to

a maximum of 5 percent (for commercial property and other land transactions) or 9 percent (for residential property). The sale of shares in a company that owns Jersey land might fall within the ambit of the Taxation (Land Transactions) (Jersey) Law. This law seeks to treat the sale of shares in a company that holds certain residential properties in Jersey in the same way as a land transaction.

Purchase of shares

As there is no capital gains tax in Jersey, acquisitions of shares are common. The purchase of a target company's shares does not result in an increase in the base cost of the company's underlying assets. It is also possible to acquire shares in a Jersey company through a public takeover offer, provided the shares of the target company are traded on a stock exchange in the UK, Channel Islands or Isle of Man, or the company is public (or considered public).

There is no exchange control in Jersey. Jersey companies may be freely incorporated with a share capital denominated in any currency. There are no restrictions on inward or outward investment or on the repatriation of dividends, interest or profits.

Tax indemnities and warranties

When the shares in a company are purchased, the buyer takes over the company's history, including all related liabilities, known and contingent. Accordingly, the sale and purchase agreement normally includes extensive tax warranties and tax indemnities. The tax indemnity sets out the procedure for dealing with tax liabilities (both known and those subsequently arising) and assigns responsibility for preparing and agreeing the company's tax returns with the Comptroller of Taxes, including how any dispute resolution would be undertaken.

A due diligence exercise initiated by the buyer includes a review of the target's tax affairs to understand the extent of any outstanding tax liabilities.

Tax losses

All existing tax losses transfer with the acquired company and can generally be offset against the future profits of that company, provided the trade does not change and other conditions are met. Brought forward losses cannot be offset against the profits of other companies in the group.

The acquisition agreement should indicate whether the buyer or the seller has the right to use the target's pre-acquisition tax losses and whether there is to be any payment for the use of pre-acquisition tax losses by the buyer.

Crystallization of tax charges

There is no capital gains tax in Jersey, so no exit charges arise on gains inherent in the business assets of the acquired company on change in ownership.

Pre-sale dividend

A pre-sale dividend is not commonly used for tax planning in Jersey. Such a dividend would create an income tax liability for Jersey resident sellers. However, no tax charge arises on gains on the disposal of shares as Jersey does not tax capital gains.

Transfer taxes

There is no stamp duty payable on the issuance or transfer of shares in a Jersey company.

Tax clearances

No specific clearances are required for the acquisition of shares. However, if the transaction is complicated, it is advisable to seek advance clearance from the Comptroller of Taxes. The Taxes Office revised its policy on the issuance of tax clearances and only provides rulings on interpretation of the law and not on administrative practices.

Choice of acquisition vehicle

Several potential acquisition vehicles are available to a foreign buyer, and tax factors will influence the decision. There is no capital duty on the introduction of capital to a Jersey company.

Local holding company

A company is regarded as being resident in Jersey where it is incorporated in Jersey or where it is incorporated abroad but its business is managed and controlled in Jersey. A company incorporated in Jersey is not tax-resident in Jersey where the company is:

— managed and controlled in another country

— tax-resident in that country

— subject to a tax by that country, the highest rate of which is at least 10 percent.

All Jersey-resident limited companies are subject to income tax on their worldwide income.

A Jersey-resident holding company is typically subject to tax at 0 percent unless it directly carries on certain financial services, utility or rental businesses. Accordingly, while interest costs associated with the acquisition may be deducted for tax purposes, there may be little benefit if the company is liable to tax at 0 percent. Note that tax losses of a company taxed at 0 percent cannot be used to offset profits arising to a company taxed at 10 or 20 percent under the group relief provisions.

Foreign parent company

The foreign buyer may make the acquisition itself. This method of acquisition does not affect the Jersey company's tax position. Note also that no withholding tax (WHT) is levied on dividends or interest paid to non-residents.

Non-resident intermediate holding company

Where the foreign country taxes capital gains and dividends received from overseas, an intermediate holding company resident in another territory could be used to defer this tax. Unlike the UK, Jersey lacks a network of double tax treaties and thus has no anti-treaty shopping provisions that would restrict the ability to use such a structure solely to obtain tax benefits.

Local branch

As an alternative to directly acquiring the target's trade and assets, a foreign buyer may structure the acquisition through a Jersey branch. A Jersey branch is subject to Jersey corporate income tax at the appropriate rate, depending on its activities. Jersey does not impose additional taxes on branch profits remitted to an overseas head office. Where the Jersey operation is expected to make losses initially, then a branch may be advantageous since a benefit may arise to the extent that the head office country's tax regime allows consolidation of losses with the profits of the head office.

Joint venture

Joint ventures can be established in Jersey through the joint venture partners either holding shares in a Jersey company or participating in a Jersey partnership (Jersey law governing general partnerships is similar to English partnership law).

The use of a general partnership could allow the joint venture partners to access initial tax losses, which could then be offset against other income, whereas the joint venture partners cannot use tax losses arising to a company. However, the liability of each partner in a general partnership is unlimited, so there are non-tax considerations that need to be addressed when determining the joint venture's structure.

Limited partnership structures are also available in Jersey. In a limited partnership, the partners are assessed individually on their partnership income. Non-resident partners are taxable in Jersey on their Jersey income, and Jersey resident partners are taxable in Jersey on their worldwide partnership income.

Choice of acquisition funding

A buyer using a Jersey acquisition vehicle to carry out an acquisition for cash needs to consider whether to fund the vehicle with debt, equity or a hybrid instrument that combines the characteristics of both.

Debt

The principal advantage of debt is the potential deduction for interest costs in computing trading profits for tax purposes, as the payment of a dividend does not give rise to a tax deduction. However, to minimize the cost of the debt, there must be sufficient taxable profits against which these expenses can be offset. As the standard rate of tax for a holding or trading company in Jersey is 0 percent (except for certain activities), there may be no profits that are suitable for relief. Therefore, the resulting tax losses would only be available for carrying forward and offsetting against any future profits of the Jersey borrower.

In determining whether sufficient taxable profits exist, losses created in the debtor company can only be group-relieved to other group companies if they are subject to the same rate of tax; in any case, the ability to group-relieve losses is not relevant between group companies that are taxed at 0 percent.

Deductibility of interest

Jersey companies generally are not obliged to make any deduction on account of any Jersey tax from any interest payments made by the Jersey company.

Interest payments made by a Jersey company on loans taken out to acquire a trading or a controlling interest in a Jersey company are tax-deductible as trading or management expenses. Where the person paying interest withdraws capital, the withdrawn amount is treated as a full or partial loan repayment and an amount equal to the interest on that portion of the loan is deducted from the eligible interest.

There are no specific transfer pricing or thin capitalization rules in Jersey that restrict the tax-deductibility of interest. However, the arm's length principle generally applies and general anti-avoidance legislation enables the Comptroller of Taxes to enforce commercial pricing between connected parties.

Withholding tax on debt and methods to reduce or eliminate it

Generally, there is no withholding tax on interest payments in Jersey.

Checklist for debt funding

- Although Jersey does not have specific transfer pricing and thin capitalization legislation, intercompany debt should be structured to ensure that it satisfies the arm's length principle.
- Consider whether the level of profits would enable tax relief for interest payments to be effective and at what rate.
- A tax deduction could be available at higher rates in other territories.
- Group relief is not available between group companies whose profits are taxed at different rates; if interest cannot be offset immediately, it can only be carried forward.

Equity

- A buyer may use equity to fund its acquisition, possibly by issuing shares to the seller in satisfaction of the consideration or by raising funds through a seller placing. The seller may also wish to capitalize the target post-acquisition.
- There is no stamp duty on the issue or transfer of shares in a Jersey company.
- Equity offers less flexibility if the parent company subsequently wishes to recover the funds it has injected but may be more appropriate if the target is loss-making or if no tax deduction is available for interest costs in Jersey.

Hybrids

Hybrid structures are unlikely to be relevant in Jersey as there is no capital gains tax. The deductibility of interest may be a

concern, however. As these structures are being restricted, specialist advice should be sought as to their tax-efficiency.

Discounted securities

The tax treatment of securities issued at a discount follows the accounting treatment, so the issuer should be able to obtain a tax deduction for the discount over the life of the security, again subject to the rate of tax at which the tax deduction is available. Jersey legislation does not allow for the deferral of the discount accruing where the borrower and lender are connected parties.

Deferred settlement

Sometimes an acquisition agreement involves an element of deferred consideration derived from the future performance of the business. In Jersey, as there is no capital gains tax, any gain arising from this unknown sum is not subject to tax.

Other considerations

Concerns of the seller

The tax position of the seller is a factor in the structure of an acquisition transaction. As there is no capital gains tax in Jersey, the seller likely would want a capital gain to arise on sale, rather than, for example, extracting some of the value of the target through a pre-sale dividend that would give rise to taxable income.

Company law and accounting

The Companies (Jersey) Law 1991 prescribes how Jersey companies may be formed, operated, reorganized and dissolved. The law allows for the formation of a number of different types of companies, such as no par value companies and cell companies. Jersey company law provides considerable flexibility in, for example, determining how companies may be reorganized. The law allows two or more companies to merge, provided none of them has unlimited shares or guarantor members.

As for mergers and acquisitions (M&A), a business combination, which International Financial Reporting Standards (IFRS) define as the bringing together of separate entities or businesses into one reporting entity, may be classified as either a merger or an acquisition. In essence, a combination is regarded as a merger where it effects a pooling of business interests (i.e. where one company's equity is exchanged for equity in another company), or where shares in a newly incorporated company are issued to the merging companies' shareholders in exchange for the equity and both sides receive little or no consideration in the form of cash or other assets.

Accounting standards predominantly determine the accounting treatment of a business combination. Generally, most combinations are accounted for as acquisitions; merger accounting is only applied in certain circumstances. Merger accounting is not allowed under IFRS; all business combinations must be accounted for as acquisitions.

The relevant UK accounting standards restrict merger accounting to (and make it obligatory for) a very small number of genuine mergers and group reorganizations not involving minority interests. Genuine mergers are those in which the shareholders come together in a partnership for the mutual sharing of the risks and rewards of the combined entity and in which no party to the combination in substance obtains control over any other or is otherwise seen to be dominant in any way. Numerous detailed conditions must be met.

One of the main practical distinctions between acquisition accounting and merger accounting is that acquisition accounting may give rise to goodwill. The net assets acquired are brought onto the consolidated balance sheet at their fair values, and goodwill arises to the extent that the consideration given exceeds the aggregate of these values.

As long as IFRS is not adopted or incorporated into UK GAAP, the goodwill is then amortized through the profit and loss account over its useful economic life. Acquisition accounting principles also apply to purchases of trade and assets, with any goodwill and fair value adjustments appearing on the acquirer's own balance sheet. In merger accounting, goodwill does not arise because the acquirer and the seller are treated as though they had operated in combination since incorporation; adjustments are made to the value of the acquired net assets only to the extent necessary to bring accounting policies into line.

Another important feature of Jersey company law concerns the ability to pay dividends. Distributions of profit may be made out of any account of the company, other than the capital redemption reserve or the nominal capital account. Directors are required to make a statement regarding the ongoing solvency of the company for a period of at least 12 months after the distribution.

Group relief/consolidation

Group relief provisions apply to companies subject to tax at 0 percent and 10 percent. The provisions only allow losses to be offset from one 0 percent company to another and from one 10 percent company to another. Thus, the situation is not straightforward for groups that comprise trading companies taxed at different rates. A company must own 51 percent of its subsidiary to be eligible for group relief.

Transfer pricing

There is no formal legislation governing transfer pricing, related-party transactions or thin capitalization. However, the arm's length principle applies and general anti-avoidance legislation enables the Comptroller to enforce commercial pricing between connected parties.

Dual residency

Subject to certain conditions, a Jersey-incorporated company managed and controlled outside Jersey, for example, in the UK, is treated as being solely tax-resident in the UK. There is no advantage or disadvantage to a company being dual resident under the Jersey tax regime.

Foreign investments of a local target company

Jersey does not have controlled foreign company (CFC) legislation. However, it is a low-tax jurisdiction, so the CFC legislation of the territory of the investing company may apply.

Mergers

It is possible for two Jersey incorporated companies to merge into a single entity and for a foreign company to merge with a Jersey company. When two companies merge, the merged company assumes the tax liabilities of both merging companies.

Comparison of asset and share purchases

Advantages of asset purchases

— Possible to acquire only part of a business.

— A step-up in the base cost of plant and machinery assets is possible.

— Capital allowances are available on the relevant part of the purchase price.

— A deduction is available for trading stock purchased.

— There is no capital gains tax payable by the seller on purchase of capital assets, such as property and goodwill.

— The historical liabilities of the company are not inherited.

— No GST is charged on a transfer of a going concern.

Disadvantages of asset purchases

— GST at 5 percent may be payable.

— Tax losses remain with the seller and cannot be used by the buyer.

— Possible need to renegotiate supply, employment and technology agreements, or to renew licenses.

— A higher outlay may be required if no liabilities are included in the purchase.

— No tax relief is available for the amortization of goodwill.

— May be unattractive to the seller since a disposal of shares would be tax-free, so the price may be higher.

— Higher transfer taxes usually arise.

Advantages of share purchases

— Tax losses remain available to be used against profits of the same trade.

— No GST on a transfer of shares.

— No stamp duty is payable on a transfer of shares.

— Capital outlay may be lower as net assets are acquired.

— Likely more attractive to the seller as Jersey has no capital gains tax.

— Less need to renegotiate contractual arrangements unless change of control provisions apply.

Disadvantages of share purchases

— Buyer effectively acquires all the history of the company and becomes liable for any claims or previous liabilities of the company, including tax.

— The purchase price is not tax-deductible.

— Acquired losses can only be used to relieve profits of the same trade and cannot be group-relieved.

Double taxation

Jersey has double taxation arrangements in place with Cyprus, Estonia, Guernsey, Hong Kong (SAR), Isle of Man, Luxembourg, Malta, Qatar, Rwanda, Seychelles, Singapore, United Arab Emirates and the United Kingdom.

Jersey also has limited agreements with Australia, Denmark, Faroe Islands, Finland, France, Germany, Greenland, Iceland, New Zealand, Norway, Poland and Sweden. These agreements generally provide for the avoidance of double taxation on certain income of individuals and income derived from the operations of ships and aircrafts.

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Luxembourg

Introduction

Luxembourg benefits from an extensive legal framework for cross-border mergers and acquisitions (M&A) involving Luxembourg entities.

Luxembourg companies may be involved in domestic and cross-border mergers and demergers in various ways. Luxembourg has implemented the European Union (EU) Merger Directive, which allows tax-neutral company reorganizations.

This report provides a general overview of tax and other issues relating to cross-border M&A in Luxembourg and clarifies the frameworks within which the different transactions may take place. The following aspects are analyzed in particular:

— opportunities available to the buyer when purchasing shares or assets

— choice of acquisition vehicles available to the buyer

— questions relating to funding of the acquisition.

Corporate law framework

Luxembourg corporate law has always been a strong support for the Luxembourg global pro-business approach. To the extent possible, corporate law rules are designed with a view to fulfilling entrepreneurs' goals and expectations. As a global financial center, Luxembourg is eager to facilitate cross-border transactions. Cross-border mergers have become a strategic concern for groups of companies over the years, either for internal restructuring or acquiring new businesses. As a result, Luxembourg saw the need for a set of rules that would fulfill these objectives.

The law of 10 August 1915 on commercial companies was first amended by the law dated 23 March 2007, which provides the current framework and facilitates mergers and divisions of Luxembourg companies.

Since 2007, cross-border mergers involving Luxembourg companies without forming a European company (*societas Europaea*) have been permitted under Luxembourg law.

Luxembourg law was ahead of most of other European jurisdictions, which did not foresee the benefits of a cross-border merger mechanism. In a nutshell, Luxembourg commercial companies were entitled to take part in cross-border mergers, either as absorbing or absorbed entities, to the extent that the legislation of the other jurisdiction did not prohibit such merger. However, the 2007 law did not provide a comprehensive legal framework.

This deficiency was resolved pursuant to the law of 10 June 2009, which transposed several EU directives relating to cross-border mergers into Luxembourg law. True to its standard proactive and business-friendly approach, the Luxembourg legislator took the opportunity to exceed the minimum requirements set forth in the EU directives.

Any Luxembourg company can be merged into a foreign company where:

— The foreign company or economic interest group is formed in accordance with the law of a foreign state.

— The law governing the foreign entity allows cross-border mergers as a matter of principle.

— The foreign entity complies with the national provisions and formalities of the foreign state.

Cross-border merger legal framework

The Luxembourg corporate law sets out a simplified framework for both domestic and cross-border mergers, easing restructuring and cooperation across borders in Europe and internationally. The Luxembourg cross-border legal framework is an example of the continuing modernization of Luxembourg company law. The framework is designed to make Luxembourg more competitive and enable domestic companies to benefit further from the single market and from the flexibility of the Luxembourg corporate law system.

Scope

The scope of Luxembourg law is wider than that of Directive 2005/56/EC, in that it allows for cross-border mergers between all types of Luxembourg companies vested with

legal personality and EU companies, as well as non-EU companies, insofar as the law of the non-EU country does not prohibit such mergers. Where one merging company operates under an employee participation system and the company resulting from the merger must also operate under such a system and is a Luxembourg company, it can only take the form of a *société anonyme*.

Luxembourg has rejected the option that the national authorities could oppose a cross-border merger on public interest grounds, as suggested in article 4 (1) (b) of Directive 2005/56/EC.

Luxembourg includes undertakings for collective investment in transferable securities (UCITS) within the scope of the law, thus allowing for mergers among Luxembourg UCITS, unlike Directive 2005/56/EC, which explicitly excludes UCITS from its scope. Luxembourg also chose to apply the law to cooperative companies.

Procedural steps for cross-border merger

The legal regime for cross-border mergers is the same as the regime applying to national mergers. This is an improvement, given that the EU directives set more stringent conditions for cross-border mergers.

Directive 2005/56/EC sets out 12 items to be included in the written 'common draft terms' of cross-border mergers that involve Luxembourg limited liability companies. The management of the merging companies must establish these draft terms. They include the same basic principles required in the common draft terms for mergers of Luxembourg companies and additional information for cross-border mergers and mergers resulting in the creation of a European company (EC).

The common draft terms of mergers must be published in the relevant national gazette at least 1 month before the general meeting of shareholders of the merging companies, which is convened to approve of the merger. The management of the merging companies must draw up a report explaining the economic and legal aspects of the merger and its impact on shareholders, employees and creditors.

For cross-border mergers, this report must be made available at least 1 month before the general meeting of shareholders of the merging companies. In the absence of unanimous approval of the merger by the shareholders of both companies, an independent expert appointed by the management of the merging companies must prepare a report on the proposed merger.

The expert and management's reports inform the decision of the general meetings of the merging companies on the proposed merger, which must be approved with the same quorums and majorities required for amending the companies' articles. The independent expert's report and relevant documents are only necessary where they are required by the national law of the absorbed or absorbing company and where the absorbing company holds 90 percent or more but not all the shares and securities that confer rights to vote in the general meetings of the absorbed company.

Validity and effect of the merger

In Luxembourg, the notary is the national authority in charge of verifying the legality of the merger and, in particular, of ensuring that the merger proposal has been agreed on the same terms by each merging company.

The notary may be required to issue a certificate attesting to the legality of the merger.

The merger is effective in relation to third parties as of the publication of the deed of the general meeting approving it or, if no such meeting is required, on publication of the notary's certificate.

Once merged, the absorbed company ceases to exist and all its rights and obligations are transferred to the absorbing company. If the cross-border merger has taken place in accordance with the law, it cannot be declared null and void.

Asset purchase or share purchase

Purchase of assets

Luxembourg tax law differs in its treatment of transfers of 'private' and 'business' assets.

For business assets (held by a company), a capital gain on disposal must be included in the business profit of the seller.

Capital gains realized on assets other than real estate or a substantial participation held as private property (i.e. not held by a company) are exempt unless they qualify as speculative gains under article 99bis of the Income Tax Law, that is, unless the gain is realized within the 6 months of the acquisition of the asset or the disposal precedes the asset's acquisition.

Liabilities associated with the transferred asset remain with the seller and are not transferred with the asset.

Purchase price

When a Luxembourg entity directly acquires a business, the acquisition price of the assets normally represents the basis for their depreciation for Luxembourg tax purposes.

The (depreciated) acquisition cost determines gains or losses arising on a subsequent disposal. However, where a business is acquired from a related party at a price deemed not to be at arm's length, a tax adjustment may be made.

Goodwill

Under Luxembourg tax law, each asset transferred should be allocated its own distinct value, which forms the base cost for depreciation purposes. Where the total value exceeds

the sum of the values attributed to each asset, the excess is deemed to constitute goodwill. In principle, goodwill is depreciable under Luxembourg tax law, and the normal practice is to write off goodwill over 10 years. However, Luxembourg companies may write off goodwill over a longer period, provided it does not exceed the useful economic life of the asset.

Financial fixed assets, such as participations, are not generally depreciable, even where there is a goodwill element in the purchase price. A deductible write-down in value is permitted following a prolonged reduction in the value of the participation.

Depreciation

Fixed assets are, in principle, subject to an annual depreciation that should be deductible from the taxable income of the Luxembourg company. Generally, the straight-line method is used to compute the amount of depreciation. The declining-balance method may be used in certain cases but not for buildings and intangible assets.

As of 1 January 2017, taxpayers can opt to defer the deduction of annual depreciation of a tangible asset. The unused amount can be carried forward and must be deducted by the end of the asset's useful lifetime. The taxpayer may change from the declining-balance to the straight-line method but not vice versa.

With the approval of the tax administration, depreciation on the basis of asset use may be applied to assets whose annual use fluctuates widely. Extraordinary depreciation may also be permitted if there is excessive wear and tear or other steep reductions in value of the assets. Buildings used for business purposes may be depreciated over their useful lives, but land may not be depreciated.

Apart from a few assets covered by administrative circulars, there are no specified rates of depreciation. The depreciation period should reflect the useful life of the asset. Rates commonly used in practice are as follows:

Buildings	1.5–5 percent
Machinery and equipment	10–20 percent
Vehicles	25 percent

Source: KPMG in Luxembourg, 2018

Reference is generally made to German rules for depreciation periods.

Tax attributes

Losses that arise on the disposal of assets may offset other taxable income of the Luxembourg company. Losses incurred before 1 January 2017 that exceed taxable income may be carried forward indefinitely against future profits of the Luxembourg entity. However, any tax losses available for indefinite carry forward of the Luxembourg company selling the assets may not be transferred to the buyer of the assets.

Losses incurred as of 1 January 2017 that exceed taxable income may be carried forward for up to 17 years.

Value added tax

The normal valued added tax (VAT) rate is 17 percent. When assets are transferred individually, the transferred items within the scope of VAT are subject to the normal VAT rules for goods and services.

However, a merger or division generally is not subject to VAT because the transfer of all assets forming all or part of a business is not deemed to constitute a supply of goods for VAT purposes. There is deemed to be continuity between the transferee and the transferor.

Stamp duty and stamp duty land tax

No stamp duty is generally payable on the transfer of assets. The transfer of immovable property is subject to registration duty of 6 percent of the value of the real estate, plus an additional transfer duty of 1 percent.

For certain real estate in Luxembourg City, there is a supplementary municipal duty of 3 percent. A registration duty of 0.24 percent applies to deeds that have to be mandatorily registered.

Purchase of shares

Generally, the purchase of a target company's shares should not affect the book values of its assets. The assets of the target company cannot be revalued to reflect fair market values.

The buyer should record the participation acquired in its balance sheet at the acquisition price, plus costs directly connected with the acquisition.

Tax indemnities and warranties

Since the buyer is taking over all the liabilities, including contingent liabilities, the buyer requires more extensive indemnities and warranties than in the case of an acquisition of assets. Due diligence of the target company's tax position is advisable, particularly when the amounts involved are significant.

In principle, indemnity payments received by a Luxembourg company pursuant to a warranty clause are taxable for the company. In principle, a Luxembourg company making such an indemnity payment may deduct it for tax purposes.

Tax losses

Generally, tax losses may only be deducted by the company that originally incurred them. Hence, where a Luxembourg company is absorbed by an existing or a newly incorporated company, its tax loss carry forward may not be transferred. However, it may be possible to disclose latent capital gains

of the absorbed company to be offset by unused tax losses. Accordingly, the absorbing company may acquire assets on a stepped-up basis on which depreciations may be computed.

As long as a Luxembourg company continues to exist following these types of restructuring, its tax losses may be carried forward in certain conditions. Conversely, where two or more Luxembourg companies are merged to create a new company, the tax loss carry forward of each disappearing entity is lost.

Crystallization of tax charges

While there are no specific rules under Luxembourg tax law, it is generally advisable that a buyer performs a due diligence to assess the tax position and related risks of the target company.

Pre-sale dividend

The treatment of pre-sale dividends (distributions by the subsidiary of retained earnings before disposal) may benefit from the participation exemption. When the subsidiary company distributes dividends to its parent company, any write-down in value of the participation held by the parent company in the subsidiary is not deductible to the extent of the amount of dividends distributed.

Stamp duty

No stamp duty is payable on the transfer of shares in capital companies. Registration duty may be levied on the transfer of all or most of the shares in certain vehicles that hold only real estate. In some cases, the tax authorities may apply a look-through and consider that the real estate, rather than the company, has been transferred and levy duty accordingly. Specific rules apply in the case of a transfer of partnership interests with underlying real estate.

Tax clearances

A taxpayer may request advance tax clearance from the tax authorities with respect to the application of Luxembourg tax law to the taxpayer's specific facts and circumstances. For transfer pricing issues, an advance pricing agreement may be requested from the tax authorities.

The advance tax clearance procedure was formalized in Luxembourg domestic law as of 1 January 2015. A ruling commission gives a binding opinion at the request of the taxpayer. An administrative fee for a ruling, ranging from EUR3,000 to EUR10,000, must be paid upfront.

The advance tax agreement is valid for a 5-year period and is binding for the tax authorities, unless the description of the situation or transactions was incomplete or inaccurate, the situation or transactions realized subsequently differ from the ones described in the request, or the decision is not or no longer in line with national, European or international law.

Choice of acquisition vehicle

Several potential acquisition vehicles are available to a foreign buyer.

A fixed capital duty of EUR75 is due on certain transactions, including, among others, the incorporation of a Luxembourg company.

Local holding company

Purchasers may choose to set up a holding company to acquire the shares of a target company.

Two legal forms of limited liability company are widely used in Luxembourg:

— Public limited company (*société anonyme*): a joint stock company with freely transferable shares. A one-person public limited company (*société anonyme unipersonnelle*) is available under the same conditions, except that the board of directors may be represented by one director and the general shareholders meeting may be attended by the sole shareholder.

— Limited liability company (*société à responsabilité limitée*): a private limited company with restrictions on the transfer of shares. Also available is a one-person limited liability company (*société à responsabilité limitée unipersonnelle*), which may have only one shareholder.

These companies are generally fully taxable corporations that may benefit from the Luxembourg participation exemption regime.

Luxembourg tax legislation also provides for the private family asset holding company (*Société de gestion de patrimoine familiale* — SPF), an investment vehicle for individuals. This type of company is specially designed to meet the business needs of family-owned holding companies managing financial assets. The exclusive objectives of an SPF are acquiring, holding, managing and disposing of financial assets, to the exclusion of any commercial activity.

Luxembourg domestic law provides for other types of entities, including:

— partnership limited by shares

— *societas Europaea*

— partnership

— limited partnership

— special limited partnership

— joint venture

— cooperative society

— civil company

— economic interest grouping.

Foreign parent company

The foreign buyer may finance the Luxembourg company with interest-bearing debts. In principle, interest payments by a Luxembourg company are not subject to Luxembourg withholding tax (WHT).

Dividend payments by a Luxembourg company generally are subject to 15 percent Luxembourg dividend WHT, but an exemption is provided under domestic tax law if certain conditions are met. The WHT can also be reduced by application of tax treaties.

No WHT tax is levied on liquidation or partial liquidation proceeds.

Non-resident intermediate holding company

Dividend payments by a Luxembourg company to a foreign entity are generally subject to a 15 percent WHT, which may be reduced a tax treaty or exempt the domestic WHT exemption regime.

This relief may be challenged by the Luxembourg tax authorities if the transaction is considered as abusive. Current and future anti-abuse rules should be considered when interposing an intermediate holding company.

A general anti-abuse rule was introduced into Luxembourg domestic tax law in order to comply with January 2015 amendment to the Parent-Subsidiary Directive. Dividends falling within the scope of the directive, which are paid by a Luxembourg fully taxable company to a collective entity listed and covered by the directive or to an EU permanent establishment (PE) of a collective entity listed and covered by the directive, will not benefit from a WHT exemption if the transaction is characterized as an abuse of law within the directive's meaning.

Luxembourg tax authorities may also ignore or recharacterize a transaction that is considered fictitious or purely tax-driven (i.e. general abuse of law principle — GAAR). It is expected that Luxembourg will adapt its long-standing current GAAR when transposing the GAAR of the EU Anti-Tax Avoidance Directive (ATAD) (i.e. by the end of 2018 for entry into force as of 1 January 2019.

Finally, in the context of tax treaties, Luxembourg has signed the Multilateral Instrument (MLI) and has decided to include in its covered tax agreements the principal purpose test as an anti-treaty abuse provision. Those provisions are not expected to apply before 2019 or 2020 at the earliest. Future tax treaties negotiated by Luxembourg may include similar anti-treaty abuse provisions.

Local branch

As an alternative to the direct acquisition of the target's trade and assets, a foreign buyer may structure the acquisition through a Luxembourg PE. The income attributable to the PE is subject to Luxembourg taxation, but dividends and capital gains realized by the PE on disposal of a shareholding in a Luxembourg company may, under certain conditions, benefit from the Luxembourg participation exemption regime. The repatriation of profits to the foreign head office does not trigger additional taxes on branch profits.

Joint venture

Whenever a joint venture takes a form in which the company is legally and fiscally recognized as an entity distinct from the participants, it is taxed as a corporation (see earlier in this report).

In other cases, the income is taxable for the individual venturers under the rules for partnerships (see earlier in this report), which is the case for European economic interest groupings (*Groupement européen d'Intérêt economique*).

The profits are allocated on the basis of the joint venture agreement.

Choice of acquisition funding

To fund an acquisition, the acquiring company may issue debt, equity or a combination of both. Below we discuss the tax aspects that should be considered when deciding the funding structure.

Debt

Interest expenses incurred to fund the acquisition of assets generally are deductible as long as the arm's length principle is satisfied.

Expenses directly related to a participation that qualifies for the exemption (e.g. interest expenses) are only deductible to the extent that they exceed exempt income arising from the relevant participation in a given year. However, the exempt amount of a capital gain realized on a qualifying participation is reduced by the amount of any expenses related to the participation, including decreases in the acquisition cost, that have previously reduced the company's Luxembourg taxable income.

In principle, no WHT is levied in Luxembourg on interest payments unless the loan is a direct profit-participating loan, bond and similar security. Further, where the recipient of the interest payments is a Luxembourg-resident individual, a 20 percent WHT may be due (Relibi) (i.e. Relibi Law: Final withholding tax on qualifying interest paid by resident paying agents to resident individuals in Luxembourg, including interest on bank deposits, government bonds, and profit-sharing bonds. Scope of the final withholding tax extended to interest, as long as they fall in the Relibi law, paid or credited by foreign paying agents located inside the EU (or another covered State situated outside the EU but inside the EEE area).

Deductibility of interest

Luxembourg tax law does not stipulate a specific debt-to-equity ratio. According to the Luxembourg administrative

practice, an interest-bearing debt-to-equity ratio of 85:15 is required to finance shareholdings. Provided the shareholders give no guarantees, third-party debt is disregarded in this computation.

Where the required ratio is not met, the portion of interest paid in excess of the ratio could be regarded, for Luxembourg tax purposes, as a hidden profit distribution. In principle, a hidden profit distribution is not tax-deductible and is subject to 15 percent WHT, subject to relief under the domestic WHT exemption rules or a tax treaty.

Luxembourg must transpose the interest limitation rules of the ATAD by the end of 2018 for application as of 1 January 2019.

Withholding tax on interest payments

Luxembourg domestic tax law does not levy WHT on arm's length interest payments, except for interest on profit-participating bonds and similar securities. In principle, interest payments on such financing instruments is subject to Luxembourg WHT of 15 percent where:

— The loan is structured in the form of a bond or similar security.

— In addition to the fixed interest, supplementary interest varying according to the amount of distributed profits is paid, unless the supplement is stipulated to vary inversely with the fixed interest.

Checklist for debt funding

— In principle, interest payments are not subject to Luxembourg WHT.

— The maximum 85:15 debt-to-equity ratio must be respected when financing participations.

Corporate income tax and minimum net worth tax

The cumulative corporate tax (municipal business tax — MBT) plus corporate income tax (CIT)) for companies established in Luxembourg City is of 26.01 percent as of 2018 (27.08 percent in 2017). Since 1 January 2016, the current minimum CIT (due by Luxembourg resident corporate taxpayers) has been abolished and replaced it by a minimum net wealth tax (NWT). Overall, the rules determining this minimum NWT are the same as those that were in force for determining minimum CIT, with some exceptions.

A minimum NWT of EUR4,815 per year is levied on incorporated collective investment entities where:

— the statutory seat or place of central administration of the company is in Luxembourg

— the financial assets (i.e. participations, transferable securities, receivables from related companies with which the company has a participating link, bank deposits and cash) exceed 90 percent of their total assets and EUR350,000.

All other Luxembourg collective investment entities having their statutory seat or central administration in Luxembourg are subject to a progressive minimum NWT based on the total balance sheet assets for the relevant tax year. The minimum NWT ranges from EUR535 for a balance sheet total up to EUR350,000, to EUR32,100 for a balance sheet total exceeding EUR 30 million.

Securitization vehicles incorporated as corporations, SICARs (*Société d'Investissement à Capital a Risque*), SEPCAVs (*Société d'Epargne-Pension Capital Variable*) and ASSEPs (Association d'Epargne-Pension) are subject to the minimum NWT. Luxembourg PEs of non-resident entities remain excluded from the minimum taxation.

Share-for-share exchange

A share-for-share exchange is the contribution of shares by the shareholders of the target company to the acquiring company against allocation of shares in the acquiring company to the shareholders of the target company, or the 'exchange' of shares in the target company against shares in the acquiring company in the context of a merger/division at the level of the shareholder of the target.

In principle, a share-for-share exchange constitutes a taxable sale followed by an acquisition by the disposing shareholder. However, Luxembourg tax law provides for tax-neutral restructuring in the following circumstances.

Article 22bis of the Luxembourg income tax law provides a limited list of share exchanges at book value that may be tax-neutral at the level of the Luxembourg shareholder (i.e. no realization of capital gains):

— transformation of the legal form of corporation to another legal form of corporation

— merger/demerger of resident companies or EU-resident companies (entities that are covered by Article 3 of the EU Directive 434/90) or capital companies or cooperative companies resident in a European Economic Area (EEA) state other than an EU member state fully subject to a tax corresponding to the Luxembourg corporate income tax

— exchange of shares (in an EU or EEA resident company or a capital company fully taxable subject to a comparable effective tax rate of 9 percent computed on a similar base as the Luxembourg rate), where the acquiring company (being a EU-resident company or a capital company fully taxable subject to a comparable effective tax rate of 9 percent computed on a similar base as the Luxembourg one) obtains the majority of the voting rights in the acquired company or increases the majority of voting rights already held.

Where this provision does not apply:

— a participation exemption may apply for qualifying investments held by resident taxable companies and qualifying branches of non-resident companies (article

166 LIR-RGD 21.12.2001) — an extensive exemption that covers capital gains triggered by a share-for-share exchange

— rollover relief may also apply where sales proceeds are invested in a qualifying asset or participation under certain conditions (article 54 LIR).

Where none of these relieving provisions can be applied, the share-for-share exchange is, in principle, fully taxable. However, where the shareholders are resident individuals, the gain is taxed only if the participation realized represented at least 10 percent of the shares of the target company. Such a gain may be taxable at half the normal rate.

Non-Luxembourg resident shareholders are taxed only where a participation representing at least 10 percent of the shares of the target company is sold within 6 months following the acquisition of the shares, or where the foreign shareholder, having been a resident of Luxembourg for more than 15 years, disposed of the participation within 5 years since becoming non-resident. Most of Luxembourg's tax treaties provide for capital gains to be taxed in the state of residence of the entity or individual realizing the gain.

Transfer of assets at book value

Article 170, paragraph 2 LIR provides for the possibility of transferring assets without the realization and thus taxation of underlying capital gains. This provision does not give a definitive tax exemption of the capital gains attached to the transferred assets but merely allows a deferral until their subsequent realization.

The following conditions must be fulfilled:

— The absorbed and absorbing company must be resident in Luxembourg (within the meaning of article 159 LIR) and fully subject to Luxembourg corporate income tax.

— The shareholders of the absorbed company must receive, in consideration of the transfer of its shares, shares of the absorbing company newly issued for this purpose. Where the absorbing company has a participation in the absorbed company, the participation must be canceled. The absorbed company must be dissolved.

— The parties must take steps to ensure that the capital gains (hidden reserves) ultimately will be taxable. Thus, the absorbing company must make an entry in its fiscal financial statements reflecting the book value of the assets transferred to it by the absorbed company.

Where the transfer is not made at book value, to the extent the value attributed to the assets exceeds their book value, this would create taxable income in the absorbed company (potentially offset by available tax losses of the absorbed company).

The higher reported amount of the assets transferred in the balance sheet of the recipient company would result in a higher depreciation of the acquisition costs of the transferred assets.

Transfer of a business by the target company

Contribution of the entire business of the target company or only an independent branch of activity can be made to an acquiring company in exchange for shares in the acquiring company (a share capital company). In this case, the target company remains in existence and, depending on the size of the companies involved, the company acquiring the business may become a subsidiary of the target company, whose sole remaining activity is the holding of shares in the acquiring company.

Article 59 LIR applies where the target company transfers either all assets and liabilities or a branch of activity (the target company remaining in existence). Under this article, in principle, hidden reserves cannot be transferred to the acquiring company because the assets involved are revalued to market value, thus exposing any increase in value over book value to taxation at normal rates at the level of the target company. Thus, the minimum value at which the acquiring company may value the assets transferred is book value.

However, where the target and acquiring companies are fully taxable companies that are resident in Luxembourg or for the acquiring company in another EU or EEA member state, articles 59(3) and 59 bis (1) LIR provide that the assets may be transferred to the acquiring company at book value, market value or an intermediate value at the election of the target company, thus deferring taxation. The maximum value at which the acquiring company may value the assets transferred is market value.

If the receiving company is resident in another EU member state, any Luxembourg-based assets must be transferred to a Luxembourg PE of that company to benefit from a tax-neutral treatment.

Anti-abuse rules

A general anti-abuse rule (GAAR) and an anti-hybrid rule were introduced into Luxembourg domestic tax law in order to comply with the amendments of July 2014 and January 2015 to the Parent-Subsidiary Directive. As of 1 January 2016, profit distributions within the scope of the directive are no longer be tax-exempt in Luxembourg where the subsidiary is a collective entity listed and covered by the Parent-Subsidiary Directive, if:

— the distributions are deductible by the payer located in another EU member state (anti-hybrid rule), or

— the transaction is characterized as abusive within the meaning of the directive (general anti-abuse rule).

A transaction may be considered as abusive if it is an arrangement, or a series of arrangements, that is not 'genuine' (i.e. that has not been put in place for valid commercial reasons reflecting economic reality) and has been put in place for the main purpose or one of the main purposes of obtaining a tax advantage that is not in line with the objective of Parent-Subsidiary Directive.

Luxembourg will also have to transpose the anti-hybrid rules of the ATAD 2 by the end of 2019 for entry into force as of 1 January 2020 (and by the end of 2021 for entry into force as of 1 January 2022 for the rules on reverse hybrids).

Luxembourg tax authorities may also apply its general abuse of law principle and ignore or recharacterize a transaction that is considered as fictitious or purely tax-driven. Luxembourg is expected to adapt its abuse of law principle when transposing the GAAR of the ATAD (by the end of 2018 for entry into force as of 1 January 2019).

Finally, in the context of tax treaties, Luxembourg has signed the MLI and has decided to include in its covered tax agreements the principal purpose test as an anti-treaty abuse provision. These provisions are not expected to apply before 2019 or 2020 at the earliest. Future tax treaties negotiated by Luxembourg may also include similar anti-treaty abuse provisions.

Discounted securities

The tax treatment of securities issued at a discount to third parties normally follows their accounting treatment under Luxembourg generally accepted accounting principles (GAAP). As a result, the issuer should be able to obtain a tax deduction for the discount accruing over the life of the security.

Deferred settlement

Where acquisitions involve elements of deferred consideration (i.e. the amount of the consideration depends on the business's post-acquisition performance), in principle, such future consideration should be regarded as part of the sale price.

Where the sale price relates to shares disposed of, the deferred settlement may be eligible for the Luxembourg participation exemption regime as an element of a capital gain on shares.

Other considerations

Concerns of the seller

A sale of shares of a Luxembourg company may be tax-exempt, where the seller is either a Luxembourg corporation under the capital gains substantial participation exemption or a non-resident. Luxembourg usually loses the right to tax capital gains under tax treaties, and non-resident sellers that do not benefit from treaty protection when disposing of shares in a Luxembourg company are not taxable in Luxembourg after a 6-month holding period has elapsed.

The sale of shares does not trigger registration or stamp duty (except in some cases where sellers hold Luxembourg real estate).

In an acquisition for cash of all the assets of a Luxembourg company, the seller is subject to Luxembourg corporation tax on any capital gains. Under certain conditions, the seller may defer taxation, for example, by reinvesting the sale proceeds in fixed assets.

Company law and accounting

Merger

Mergers of two or more Luxembourg public limited companies (SA) can be effected only by absorption of an existing company or incorporation of a new entity. In both cases, the target companies of the merger are dissolved without liquidation, and all assets and liabilities are contributed to the absorbing or newly created entity.

The law of 23 March 2007, as further detailed by the law of 10 June 2009, amended Luxembourg company law to simplify the rules and conditions for mergers and divisions. This law allows a cross-border merger between any Luxembourg company with a legal personality and companies governed by a European or foreign law, where the national law of the relevant country does not oppose such merger (entities with legal personality are the *société anonyme, société en commandite par actions, société à responsabilité limitée, société en nom collectif, société en commandite simple, the société coopérative, société civile, and groupement d'intérêt économique*).

A merger can also occur where one or more of the companies or economic interest groupings that are acquired or will cease to exist are the subject of bankruptcy proceedings relating to litigation with creditors or a similar procedure, such as the suspension of payments, control of the management of the company, or proceedings instituting special management or supervision of one or more of such companies.

A merger is effected by the acquisition of one or more companies by another (merger by acquisition) or by the incorporation of a new company (merger by incorporation of a new company). In exchange, the shareholders receive shares and possibly a cash payment not exceeding 10 percent of the nominal value of the shares issued. In both cases, the target companies of the merger are dissolved without liquidation, and all assets and liabilities are transferred to the absorbing or newly created entity.

Division

Luxembourg company law defines a division as a transaction in which the company being divided, after dissolution but

without going into liquidation, contributes its assets and liabilities to two or more pre-existing or newly formed companies (the recipient companies) in exchange for the issue of shares to shareholders, possibly with a cash payment not exceeding 10 percent of the nominal value of the shares issued.

The law of 23 March 2007 simplified the rules and conditions for mergers and divisions. This law allows a cross-border division between any Luxembourg company having a legal personality and a European or a foreign law-governed company where the national law of the relevant country agrees.

Group relief/consolidation

Fiscal consolidation is allowed for corporate and business tax purposes but not for net worth tax purposes. Domestic provisions allow eligible companies to set up a vertical or (as of 1 January 2015) horizontal tax consolidation group (subject to conditions). The consolidated companies are bound for a 5-year period.

Vertical consolidation

A fully taxable resident company or a Luxembourg PE of a non-resident company fully subject to a tax comparable to the Luxembourg corporate income tax, of which at least 95 percent of the capital is directly or indirectly held by another fully taxable resident company, or by a Luxembourg PE of a non-resident company fully subject to a tax comparable to the Luxembourg corporate income tax, may apply for tax consolidation with its parent company.

To comply with EU law, the scope of eligible subsidiaries was expanded as of the 2015 tax year to include a Luxembourg PE of a non-resident company fully subject to a tax comparable to the Luxembourg corporate income tax.

Vertical tax consolidation means that the taxable income (whether negative or positive) of the integrated subsidiary is added to the taxable income of the integrated parent so that the integrated parent is taxed on the aggregate taxable income.

Horizontal consolidation

In order to comply with EU law, new measures were introduced with effect from tax year 2015 that provide for the possibility to apply for a so-called 'horizontal' tax-consolidated group, whereby eligible sister companies can form a tax-consolidated group without their parent company.

The setting-up of a horizontal tax consolidated group is subject to the following conditions:

— The non-integrating parent company must be either a fully taxable resident company, or a Luxembourg PE of a non-resident company fully subject to a tax comparable to the Luxembourg corporate income tax, or an EEA resident company fully subject to a tax comparable to the Luxembourg corporate income tax, or an EEA PE of a non-resident company, both fully subject to a tax comparable to the Luxembourg corporate income tax.

— The integrated subsidiaries must be either a fully taxable resident company or a Luxembourg PE of a non-resident company fully subject to a tax comparable to the Luxembourg corporate income tax.

— The integrating subsidiary must be either a fully taxable resident company or a Luxembourg PE of a non-resident company fully subject to a tax comparable to the Luxembourg corporate income tax.

— The integrated subsidiaries and the integrating subsidiary must be held for at least 95 percent (directly or indirectly) by the same non-integrating parent company.

— The integrating subsidiary must have in the group structure a holding relationship with the non-integrating parent company that is at least as close as one of the other integrated subsidiaries.

— The request to be filed (see below) needs to designate this parent company.

— Horizontal tax consolidation means that the taxable income (whether negative or positive) of the integrated subsidiaries is added to the taxable income of the integrating subsidiary so that the integrating subsidiary is taxed on the aggregate taxable income.

Tax consolidation is also available for participations held indirectly through a non-resident fully taxable capital company, to the extent that all the other conditions are fulfilled.

In exceptional cases, the 95 percent interest requirement may be reduced to 75 percent.

The condition with respect to the holding percentage must be met at the beginning of the financial year for which the consolidation is requested.

The General Tax Law was modified with effect as of 1 January 2015 to facilitate the recovery of tax claims within the tax-consolidated group and ensure that each group member can be held liable for the taxes due by the parent company or the integrating subsidiary of the tax-consolidated group (in case of default of the latter).

SICARs and SVs are excluded from the tax-consolidation regime.

Transfer pricing

The arm's length principle is used for evaluating the conditions agreed between related parties (article 56 LIR) and applies

to all related-party transactions. Thus, both cross-border and domestic transactions must be in line with the arm's length principle.

In addition, taxpayers must be able to justify the financial information (including transactions with related entities) in their tax returns. Taxpayers should be able to provide the Luxembourg tax administration with transfer pricing documentation sustaining the arm's length character of their intra-group transactions. The transfer pricing report can either be submitted directly with the tax return or on request of the tax authorities.

The Luxembourg transfer pricing rules provide that if one or several transactions cannot be observed between independent parties and no commercial rationale for such transactions could be identified, then such (part of) transactions may be disregarded for transfer pricing purposes.

Where transactions between a parent company and a subsidiary take place, a non-taxable capital contribution or non-deductible profit distribution may be assumed if that transactions are not considered to be at arm's length. In principle, such distribution is also subject to dividend WHT.

For intragroup financing companies, the Circular LIR 56/1–56bis/1 generally refers to the OECD guidelines and provides for the application of the arm's length principle for Luxembourg entities that principally conduct intragroup financing transactions. The circular also outlines minimum equity requirements and defines, among others, an arm's length remuneration for intragroup financing activities and the appropriate level of substance for such activities.

Dual residency

Resident companies are defined for tax purposes as companies that have their legal seat or central administration in Luxembourg. Corporate income tax is levied on worldwide income and capital gains of resident companies. In the case of dual residency, tiebreaker clauses in tax treaties generally determine the tax residence of a company.

Foreign investments of a local target company

Luxembourg tax law does not currently include CFC legislation.

However, Luxembourg must transpose the CFC rules of the ATAD by the end of 2018 for entry into force as of 1 January 2019.

Comparison of asset and share purchases

Advantages of asset purchases

— Buyer may depreciate the purchase price of assets acquired.

— Possible to acquire only part of the business.

— Losses within the acquiring group may be absorbed by a profitable business acquired from the target company.

— Buyer generally is not liable for claims on or previous liabilities of the target company.

Disadvantages of asset purchases

— The business is effectively being carried on by another entity, which may require renegotiation of trading and employment contracts, etc.

— Pre-acquisition losses incurred by the target company are not transferred with the business. They remain with the target company or are lost.

— Generally, there is a need to renegotiate supply, employment and technology agreements.

— Registration duties are due on transfers of real estate.

Advantages of share purchases

— Contractual continuity because the target company may remain active, with only the shareholders changing.

— Pre-acquisition tax losses incurred by the target company may be retained, despite the change of shareholder, if certain conditions are met.

— The acquiring group companies may use losses incurred by the target company following an acquisition under fiscal integration provisions (excluding losses incurred prior to the fiscal consolidation).

— Losses incurred by acquiring group companies within fiscal integration may be offset against profits of the target company.

Disadvantages of share purchases

- Participation cannot be amortized.
- There is liability for claims on or previous liabilities of the target company.
- Where the participation exemption applies, direct funding costs related to the acquisition of the subsidiary may not be entirely deductible.

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Malta

Introduction

Malta is seeking to strengthen its status as a jurisdiction of choice for both the financial services and high-tech manufacturing sectors, which, together with tourism, form the bedrock of the Maltese economy. The Maltese legislature has undertaken a number of initiatives to simplify the legal and tax framework for cross-border mergers and acquisitions (M&A) involving Maltese entities. To this end, Malta has fully implemented the European Union (EU) Merger Directive, which provides possibilities for tax-neutral company reorganizations in addition to those that were already available under Maltese domestic law.

In recent years, Malta has emerged as a jurisdiction of choice for multinationals seeking a cost-effective, tax-efficient jurisdiction within the EU. This is due to a number of factors, including Malta's:

— legal, regulatory and fiscal framework

— use of English as the business language

— qualified workforce including legal, tax and financial services professionals

— relatively low operating costs.

Under Maltese law, M&A can be achieved in various ways, such as purchase of assets, purchase of shares, purchase of going concern or exchange of shares. Further, the Maltese Companies Act provides that two or more companies may be amalgamated through a merger by acquisition or a merger by formation of a new company.

This report provides a general overview of tax and other issues relating to cross-border M&A in Malta and clarifies the frameworks within which the different operations may take place. In particular, the following aspects are addressed:

— implications of acquiring either the target's shares or its assets

— choice of acquisition vehicle

— funding of the acquisition.

Recent developments

Domestic M&A activity has remained stable, driven mainly by the consolidation of smaller firms into larger economic entities to reduce fragmentation and by strategic acquisitions by the larger corporates to generate synergies. This activity has also seen foreign corporations either acquiring the majority stakes in previously wholly domestically owned businesses or taking stakes in joint ventures with domestic investors.

Internationally, there has been significant interest from foreign companies seeking to set up a European business base in Malta by either establishing a Maltese company that would then acquire another European company or group or by a cross-border merger. Indeed, Malta has experienced an increasing level of international M&A activity through either:

— establishment in Malta of foreign-owned holding companies used as vehicles for the acquisition of businesses in other jurisdictions

— acquisition of a Maltese holding company that itself owns business interests in one or more other jurisdictions.

Asset purchase or share purchase

Asset and share purchases have different tax consequences for the seller and buyer.

In a share deal involving a company that does not own non-business Maltese real estate, a seller who is not resident in Malta has no exposure to tax on capital gains. By contrast, an asset deal involving a Maltese business owned by a company resident and domiciled in Malta normally exposes the company to tax on capital gains from the transfer of the business and the recapture of previously claimed tax depreciation.

For the buyer, an asset deal generally presents advantages. The tax depreciation is calculated on the amounts at which assets are acquired, avoiding the need to undertake extensive due diligence regarding the assets, liabilities and obligations inherent in acquiring a company.

Purchase of assets
Implications for the seller

A transfer of a business or business assets normally is subject to capital gains tax at the rate of 35 percent. However, the effective tax suffered in Malta may be reduced to 5 percent under Malta's full imputation and tax refund system on profit distributions. Where the seller is a company resident in Malta (by virtue of central management and control) but not domiciled (incorporated) in Malta and the transfer comprises capital assets (business/shares and other assets) not situated in Malta, no exposure to Maltese tax arises. Such a resident non-domiciled company is only taxable on its Maltese source income/capital gains and on foreign-source income that is actually received in Malta.

The Income Tax Act (ITA) provides for an exemption from such tax where assets are transferred between companies that are deemed to be a 'group of companies' for ITA purposes. A 'group of companies' is defined to include companies that are controlled and beneficially owned directly or indirectly as to more than 50 percent by the same shareholders. This is further qualified for intragroup transfers of immovable property situated in Malta or securities in a 'property company' (essentially defined as a company that owns immovable property in Malta, directly or indirectly, through its shareholdings in other bodies of persons). In this case, the ultimate beneficial shareholders of the transferor and transferee companies must be substantially the same, with only a 20 percent variance in each individual's shareholding in the two companies ('immovable property group exemption'). Where the applicable conditions are met, no loss or gain is deemed to have arisen from the transfer. The cost base of the assets does not increase for tax purposes, but the tax on the capital gain is deferred until a subsequent transfer outside the group.

As Malta has fully implemented the EU Merger Directive (90/434/EEC), qualifying cross-border mergers that do not meet the conditions for these exemptions could be achieved tax-neutrally under the directive.

Value added tax

Goods and services that fall within the scope of Maltese valued added tax (VAT) are chargeable at the rate of 18 percent. However, the transfer by a person of assets of its economic activity is neither a supply of goods nor a supply of services and thus falls outside the scope of Maltese VAT, provided all of the following conditions are met:

— The assets are transferred to a person duly registered under Article 10 of the VAT Act to whom the transferor transfers their economic activity or part of that economic activity that is capable of separate operation as a going concern.

— The transferee will use the assets in carrying on the same kind of activity, whether or not as part of an existing economic activity, as that carried on by the transferor.

— The transfer is recorded in the records of the transferor indicating the registration number of the transferee.

Where the transferee is not registered under article 10, the above provision may still apply, provided it is proved to the Commissioner for VAT that the transferor did not qualify for a credit of the input tax attributable to the acquisition and the accumulation of the assets being transferred.

Implications for the buyer

Purchase price

In principle, the purchase of assets may increase the cost base for the buyer while a gain from the sale is taxable for the seller. However, Maltese tax law only imposes a tax on transfers of certain prescribed capital assets.

For tax purposes, it is necessary to apportion the total consideration among the assets acquired. Where the purchase agreement specifically stipulates the purchase price for each asset acquired, the allocation generally is accepted for tax purposes. Although Malta does not have any transfer pricing legislation, the amounts stipulated in the purchase agreement should approximate fair value. An acquisition of assets must be accounted for in accordance with International Financial Reporting Standards (IFRS) 3, which requires the purchase price to be allocated to the identifiable assets acquired on the basis of their fair value. Where the purchase agreement does not specifically allocate the purchase price to the various assets acquired, the IFRS accounting values are generally recognized for tax purposes.

Goodwill

Goodwill is the amount by which the total purchase price exceeds the value of identifiable tangible and intangible assets. Goodwill is not deductible for tax purposes.

Tax depreciation

Tangible assets, plant and machinery (including computers and software), and industrial buildings and structures can be depreciated for tax purposes. Tax depreciation for plant and machinery is calculated on the straight-line method over the minimum number of years. Tax depreciation for industrial buildings or structures (excluding land) comprise an initial allowance of 10 percent plus a straight rate not exceeding 2 percent per year. Where the acquiring and selling company are related (50 percent shareholding or both owned and controlled 50 percent by same shareholder), the wear and tear deductions for the acquiring company are computed on the lesser of:

— the written-down value of the asset for the seller

— the buyer's acquisition cost.

On disposal of a depreciable asset, further tax depreciation or recapture of tax depreciation previously claimed may result, depending on whether the disposal proceeds are less or more than the tax base cost.

Step-up in base cost on cross-border merger

On a cross-border merger, a Maltese surviving company may elect an acquisition cost of fair market value at the time of acquisition in cases where the assets were previously situated outside Malta and owned by a merging company that was not domiciled and/or resident in Malta before the merger. This stepped-up value is the tax base value for all tax purposes in Malta, including tax depreciation/amortization and eventual sale. The election must be made in the year following the year in which the merger occurs.

Tax attributes

Where a transfer of assets takes place pursuant to a merger/division under the terms of the Companies Act, the acquiring company succeeds to all the assets, rights, liabilities and obligations of the companies being acquired, including any domestic unutilized tax depreciation and tax losses. In all other acquisitions and share exchange transactions, unutilized tax depreciation and tax losses cannot be transferred between different legal entities.

Value added tax

If the seller has charged VAT, the buyer may or may not be able to recover the VAT, depending on the nature of the buyer's business.

Duty on documents and transfers

Where the merger involves the transfer of immovable property or shares in companies having 75 percent or more of the value of fixed assets being Maltese immovable property, a duty of 5 percent is normally payable unless the immovable property group exemption applies. Further, where the merger involves the transfer of shares, a duty of 2 percent may be payable unless one of the numerous exemptions apply.

The duty is payable on the higher of the consideration or market value. In practice and in accordance with the Civil Code, the buyer normally pays the duty. However, the law provides that the seller and the buyer are jointly and severally liable for the payment of the duty.

Main advantages for buyer

An advantage of an asset purchase over a share purchase is that the tax cost base of depreciable assets may increase and new intangible assets (e.g. intellectual property rights internally generated by the target) may be created on which the acquiring company may claim tax deductions. Where a purchase of assets is financed by debt, the interest expense is incurred by and deductible for the operating company, thus ensuring that it is immediately utilized against operating profits.

Purchase of shares
Implications for the seller

Generally, a seller is subject to tax on the chargeable gain on the transfer of shares at the rate of 35 percent except in the following circumstances:

— The group exemption or immovable property group exemption applies.

— The transfer is an exchange of shares with no change in ultimate beneficial shareholders or their respective holdings.

— The seller is not resident in Malta and is not owned or controlled by individuals ordinarily resident and domiciled in Malta, and the target company does not own, directly or indirectly, non-business Maltese immovable property.

— The participation exemption applies; generally, this applies to holdings of 10 percent or more in resident and non-resident companies that do not own, directly or indirectly, non-business Maltese immovable property.

— The seller is not domiciled in Malta and the shares disposed of are in a company not resident or domiciled in Malta.

Implications for the buyer

On a share deal, the tax base cost of the assets of the target company remain unchanged. The buyer can apply a step-up the base cost to market value if the tax residence of the target company is transferred to Malta or if the target company is re-domiciled to Malta.

Payment for indemnities and warranties

Subject to the terms of the sale-purchase agreement, an amount received or payment pursuant to warranty provisions is normally regarded as capital in nature and constitutes an adjustment to the agreed purchase price.

Unutilized tax depreciation and tax losses

The acquiring company generally inherits unutilized tax depreciation and tax losses. However, where the shares in a company are acquired solely or mainly for the purpose of acquiring a tax advantage, unutilized tax depreciation and tax losses may be lost.

Crystallization of tax charges — de-grouping provisions

Where the target company acquires an asset from a group company that is exempt under the immovable property group exemption within 6 years of the acquisition of the target and the acquisition causes the target to cease being part of the original group, the previously exempt gain crystallizes in the hands of the target company. Provision for this liability should be taken into account in establishing the transfer price. Alternatively, the liability may be transferred to a company of the seller by joint election, subject to certain conditions.

Pre-sale dividend

Given Malta's imputation and tax refund system, in the vast majority of cases, it is normally beneficial for the seller to realize part of its value in the target by paying dividends or simply declaring them, which creates a liability for the target. The payment normally results in no further tax.

The seller may also be entitled to claim tax refunds (normally, 6/7 of the 35 percent Malta tax charge) from the Maltese tax authorities and the sales proceeds may be correspondingly reduced.

Duty on documents and transfers

Unless the immovable property group exemption applies, duty at the rate of 5 percent is due where Maltese immovable property accounts for 75 percent or more of the fixed asset value of the target company or group. In other cases, a duty of 2 percent is due on the transfer of shares; however, the law provides for a number of exemptions that typically exempt most international M&A activity from this 2 percent duty.

Choice of acquisition vehicle

Several potential acquisition vehicles are available for achieving a merger or acquisition. The tax implications ultimately influence the choice of vehicle. There is no capital duty on introducing capital into a Maltese company or branch or a Maltese-registered societas Europaea.

Local holding company

A Maltese holding company is taxed as an ordinary company at the standard corporate tax rate of 35 percent. However, under Malta's imputation tax system, no tax is payable on dividends received from resident companies. Moreover, on the receipt of dividends from other resident companies, the holding company may claim tax refunds, which generally reduce the Maltese tax to between 0 and 6.25 percent.

These tax refunds may also arise as a consequence of debt financing since the interest expense is deductible against dividends received, thus releasing all or part of the underlying tax on the dividends as a tax refund.

Where certain conditions are met (i.e. 10 percent holding), a participation exemption should apply to any income derived from non-resident companies and to gains arising from the disposal of shares in resident and non-resident companies.

Where Malta is chosen as the domicile of an acquisition vehicle that will acquire non-resident companies, it is beneficial to use a company not domiciled/incorporated in Malta but resident in Malta by virtue of the exercise of central management and control (effective management) in Malta. Such a company is only subject to Maltese tax on Maltese source income and gains and on foreign income actually received in Malta; the company is not taxed on foreign source capital gains even if received in Malta. Such a company may thus benefit from Malta's network of tax treaties.

Malta does not levy any withholding taxes (WHT) on dividends, interest and royalties.

Foreign parent company

The use of a foreign parent company as the acquisition vehicle does not create any advantages or disadvantages from a Maltese tax perspective. The foreign parent is entitled to any dividends, interest or royalties without any Maltese WHT. The parent is also entitled to tax refunds paid by operating distributing companies in the same way as a Maltese holding company, thus reducing the Maltese tax liability to between 0 and 6.25 percent. However, the receipt of dividends and tax refunds by the foreign parent may expose it to tax on the dividend and/or tax refund in its country of residence.

Non-resident intermediate holding company

See 'Foreign parent company' above.

Local branch

Where a branch of a foreign company undertakes the acquisition of the target's business, as the foreign company is a person not resident or domiciled in Malta, it is subject to tax only on Malta source income and capital gains. Malta source income includes profits derived from any trade/business that is carried out from Malta. Any foreign-source income and gains derived would not be taxed in Malta even if the proceeds were received in Malta. Non-trading income, such as dividends received from companies not resident in Malta, is regarded as foreign income accruing to a person not domiciled and not resident in Malta, so it is outside the scope of Maltese taxation. Such non-trading income is not normally attributable to the trading activity of the Maltese branch.

The profits (determined in the normal way) of the Maltese branch are taxed at 35 percent in the same way as a company resident in Malta is taxed. On a distribution of such profits by the foreign company of which the Maltese branch forms part, the shareholders of the foreign company are entitled to claim the applicable tax refunds from the Maltese tax authorities, which reduces the tax burden to between 0 and 6.25 percent. Further, Malta does not impose any WHT on branch profits.

Joint venture

Joint ventures do not have a specific legal form under Maltese law and can be conducted through partnerships, limited liability companies or contractually. Where a legal form is not established or a partnership is established, the partners are generally assessed on their share of the profit of the joint venture. The use of partnerships in Malta as the medium to carry out an activity may not always be beneficial since the tax refunds that reduce the Maltese tax burden to between 0 and 6.25 percent may not always be available. However, as of the 2016 assessment year, the partnership may elect to be treated as a company, thereby allowing the application of the tax refund system.

Choice of acquisition funding

In Malta, both equity funding and debt funding are beneficial from a tax perspective. Equity funding (including non-statutory equity such as shareholders' contributions) maximizes the notional interest deduction, while debt funding (including profit-participating loans, which are regarded as pure debt for Maltese tax purposes) allow the deduction of actual interest expenses.

Debt

As mentioned, the advantage of funding the acquisition with debt is that the ITA provides a tax deduction where interest is payable on capital employed in acquiring income. In addition, Malta does not levy any WHT on interest and does not have any thin capitalization rules. By contrast, dividends are not deductible for tax purposes in Malta.

Deductibility of interest

Maltese tax law provides for the deductibility of interest incurred on money borrowed, provided that the interest is payable on capital employed in acquiring income.

This deduction rule has the following implications for the buyer:

— In an asset purchase deal partly or wholly financed by debt, the acquisition vehicle acquires the business or business assets and becomes the operating entity, in which case the interest expense is deductible against income derived from the business or business assets.

— In a share purchase deal partly or wholly financed by debt, the acquisition vehicle acquires shares in a Maltese operating company or companies. Whichever acquisition vehicle is used, the relative interest expense is not deductible against the profits of the Maltese operating companies but is tax-deductible against dividends received by the acquisition vehicle from the operating companies. As a result of this deduction, the Maltese underlying tax attaching to the dividends received is wholly (where the interest expense is equal to or exceeds the dividend received) or partially refunded. Any interest expense in excess of dividends received does not constitute a tax and is lost. For these reasons, it is normally beneficial to merge the acquisition vehicle with the operating company or companies, so the operating companies can deduct the interest expense. As a result of the tax refund system, the Maltese tax on distributed profits after the deduction of interest expense ranges from 0 to 6.25 percent.

Malta does not have any thin capitalization rules, so there is no limit on the amount of debt financing. Further, Malta does not have transfer pricing rules, although a general anti-avoidance provision may apply in limited circumstances.

Withholding tax on debt and methods to reduce or eliminate it

Under Maltese tax legislation, interest paid to a non-resident is not subject to tax (by withholding or otherwise), provided that the debt claim for which the interest is paid is not effectively connected with a permanent establishment of the non-resident in Malta.

Checklist for debt funding

— Malta has no thin capitalization or transfer pricing rules.

— Interest on debt is tax-deductible against income derived from the capital borrowed.

Equity

A buyer may use equity to fund its acquisition with no limitation. This includes the ability for the acquiring entity to issue shares to the seller in full or partial satisfaction of the consideration. Further shares may be issued after the acquisition.

Malta does not levy any stamp duty or other type of capital tax on the issue of shares. Malta does not levy any WHT on the payment of dividends to non-residents. Dividends are not deductible for tax purposes.

Shares may be issued at their nominal value or at a premium, which company law treats as statutory share capital. Subject to certain conditions, the acquisition of a target in consideration for the issue of shares may be exempt from the requirement to account for the inherent share premium in a share premium account.

Notional interest deduction

A notional interest deduction (NID) in force 2018 and later assessment years was introduced to achieve equal treatment of debt and equity financing, by granting an additional deduction for the return on equity financing. The NID may also simplify Malta's full imputation system since imputation credits are reduced as a result of claiming the NID.

The NID is optional and can be claimed by companies and partnerships resident in Malta (including Maltese permanent establishments of foreign entities) against their chargeable income for the year.

The NID is calculated by multiplying the deemed notional interest rate by the undertaking's balance of risk capital at year-end. The notional interest rate is the risk-free rate for Malta government stocks with a remaining term of about 20 years (currently about 2 percent) plus a premium of 5 percent. Thus, the NID rate at the time of writing would be expected about 7 percent.

For NID purposes, risk capital includes share capital, share premium, reserves, interest free loans and any other item shown as equity in the financial statements as at year end. The maximum deduction in a year cannot exceed 90 percent

of chargeable income before deducting the NID. Any excess can then be carried forward to the following year. Remaining chargeable income is subject to tax at the standard rates.

Where a company or partnership claims a NID, the shareholder or partner is deemed (for tax purposes) to have received the corresponding notional interest income from the company or partnership. Distributions of profits relieved from tax by the NID, however, are not charged to tax. The legislation includes an anti-avoidance provision to prevent abuses of the NID.

Tax-free reorganizations

As mentioned earlier, exemptions in Maltese law enable various reorganizations to be achieved in a tax-neutral manner.

Hybrids

A profit participating loan or a loan with any other mixture of the characteristics of both debt and equity could be used to finance the acquisition of a Maltese entity. From a Maltese viewpoint, such arrangements are treated as loans, so the interest is deductible in Malta.

Discounted securities

The discount or premium payable on the issue of securities is normally treated as a tax-deductible interest cost of finance akin to interest. The amount of the interest is computed using the amortized cost method in compliance with International Accounting Standards (IAS) 39, using the effective interest rate method.

Deferred settlement

Where acquisitions involve elements of deferred consideration (i.e. the amount of consideration depends on the business' post-acquisition performance), the unknown future consideration is regarded as part of the sale price and, if taxable, it is normally only taxable on receipt. Where the sale price relates to shares disposed of, the deferred settlement may be eligible for the participation exemption in the same way as the remainder of the consideration.

Other considerations

Concerns of the seller

In structuring any transaction, the buyer and seller have competing demands, especially where a Maltese situs business is the subject of the sale. The buyer normally prefers an asset purchase deal. The seller normally prefers a share purchase deal in light of the various exemptions and mitigations available, which include:

— non-resident exemption

— resident non-domiciled exemption

— participation exemption

— pre-sale dividend.

Usually, other tax-efficient structuring is also possible, depending on the circumstances.

Company law and accounting

The Companies Act 1995 regulates the formation, liquidation, amalgamation, division and conversion of companies. In summary, the main provisions are as follows:

— An amalgamation or merger is the process whereby a company (the acquiring company) acquires all the assets, liabilities, rights and obligations of another company (the company being acquired) in consideration for the issue by the acquiring company of shares to the shareholders of the company being acquired plus a cash payment not exceeding 10 percent of the nominal value of the shares issued. The acquiring company may either be an existing company or a new company incorporated as part of the merger process. The company or companies so acquired then cease to exist by operation of law without having to be wound up.

— A division of a company is achieved by a company (the company being divided) delivering its assets, liabilities, rights and obligations to one or more companies (the recipient companies, which can be existing or incorporated on achieving the division) in exchange for the issue of shares by the recipient companies to the shareholders of the company being divided, which ceases to exist by operation of law, plus a cash payment of 10 percent of the nominal value of the shares issued.

— A company may also be converted into a partnership, which may be a general partnership, a limited partnership or a limited partnership the capital of which is divided into shares.

— Any foreign company may be re-domiciled (continued) into Malta as a company incorporated in Malta and any Maltese company may be re-domiciled out of Malta to a foreign jurisdiction that has legislation allowing the continuation of companies in and out of that jurisdiction.

— Through the application of the implemented EU company law Merger Directive, mergers and division of companies as mentioned may also be carried out cross-border with companies incorporated in other EU member states. The general rule continues to be that the company law procedure usually followed in a cross-border merger is the company law of the country in which the resultant company or companies (acquiring company or recipient companies) will remain.

Among other things, the procedure to effect a merger or a division involves preparing the draft terms of merger and division, which must be filed with the Registrar of Companies for registration and approved by a shareholders' extraordinary resolution (of each of the companies involved in the merger

or division) within 1 month of the registration. The companies may be required to redeem the shares of any dissenting shareholders.

Company law in Malta requires the application of the General Accounting Principles for Small and Medium-Sized Entities (GAPSME) for qualifying entities that do not exceed the qualitative and quantitative criteria. Companies that are not eligible to adopt GAPSME are required to apply IFRS as adopted by the EU in the preparation of financial statements. Companies that are eligible to apply GAPSME may also have an option to apply IFRS as adopted by the EU (EU-endorsed IFRS).

EU-endorsed IFRS may differ from IFRS as published by the International Accounting Standards Board (IASB) if, at any point in time, the EU has not endorsed new or amended IFRS. The accounting guidance provided by IFRS on M&A has undergone significant amendment since 2004.

The definition of a 'business combination' refers to a transaction or other event in which an buyer obtains control of one or more businesses. The GAPSME definition of 'business combination' is largely the same as under IFRS.

Mergers are transactions in which the shareholders come together in a partnership for the mutual sharing of the risks and rewards of the combined entity and in which no party to the transaction in substance obtains control over any other, hence obviating the IFRS requirements for business combinations.

IFRS does not allow merger accounting or the pooling of interests method as an alternative to acquisition accounting (or the 'purchase method' as previously referred to in the 2004 version of IFRS 3). After the pooling of interests method was abolished, IFRS provided additional guidance on the identification of the buyer in a business combination (or acquisition), restricting such guidance to accounting for acquisitions.

The acquisition method always views a combination from the buyer's perspective, where the identifiable assets acquired and liabilities assumed are measured at their acquisition date fair values. The buyer is required to recognize goodwill acquired in the business combination as an asset and initially measure that goodwill at its cost. The cost is the excess of the cost of the business combination over the buyer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities recognized. After initial recognition, the buyer is required to measure the goodwill at cost less any accumulated impairment losses. The buyer does not amortize this goodwill but tests it annually for impairment.

IFRS is silent on the accounting for the combination of entities or businesses under common control of corporate entities or individuals. Such arrangements include mergers as defined earlier. For similar transactions, IFRS requires management to use its judgment in developing an accounting policy that is relevant and reliable. In exercising its judgment, management may consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework. In practice, entities apply either the book value (carry-over) basis accounting method or the purchase method in accounting for business combinations involving entities under common control.

IFRS is also silent on the accounting for the formation of a jointly controlled entity. In practice, jointly controlled entities apply the principles of accounting for business combinations by analogy in measuring the fair values of the contributed assets, including the requirements for recognition and fair value measurement of contributed contingent liabilities.

When two or more entities that are ultimately controlled by the same party both before and after the business combination are merged, GAPSME allows the book values of shares held in the capital of an entity included in the consolidation to be set off against the corresponding percentage of capital, with the difference added to or deducted from consolidated reserves.

The Companies Act also requires the preparation of consolidated financial statements, although a number of exemptions are available where certain conditions are met. These exemptions apply where:

— the group is a small group for which thresholds relative to turnover, total assets and employees are not exceeded

— the parent is the subsidiary of an entity that prepares consolidated financial statements as required by the Companies Act

— the shares in a subsidiary were acquired and held exclusively with a view to their subsequent resale, and the shares were not previously included in the parent's consolidated financial statements

— severe long-term restrictions substantially hinder the parent company's exercise of rights over the assets or management of the subsidiary

— the subsidiary is not considered as material for the purpose of giving a true and fair view; however, two or more subsidiaries may be excluded only if their inclusion is not material when taken together.

Group relief/consolidation

Maltese tax legislation does not provide for full tax consolidation. Nevertheless, group relief may be claimed provided that certain conditions are met:

- The surrendering and claimant company must fall within the scope of the ITA's group relief provisions. Thus, both companies must be resident for tax purposes in Malta and not resident in any other country. Further, the companies are deemed to be members of the group if one is the majority shareholder of the other or both are subsidiaries of a third company resident in Malta that is the majority shareholder. The term 'majority shareholder' refers cases where the parent company owns, directly or indirectly, more than 50 percent of:
  - the ordinary share capital and voting rights of the subsidiary
  - any profits of the subsidiary available for distribution
  - any assets of the subsidiary available for distribution on a wind-up.
- Both companies must be members of the same group, as defined above, throughout the year preceding the year of assessment for which the relief is claimed.
- In the year in which the surrendering company incurs an allowable trading tax loss, both companies must have accounting periods that begin and end on the same dates (other than for newly incorporated companies and companies that are wound up).
- A claim for group relief must be made by means of a certificate signed by both companies and furnished to the Maltese tax authorities within 12 months following the end of the company's accounting period.

Transfer pricing

Malta does not impose specific transfer pricing rules.

Dual residency

A company incorporated in another country and deemed to be tax resident therein as a result may also be tax-resident in Malta by reason of its effective management being exercised in Malta. Under Malta's tax treaties, such a company is treated as resident in Malta if its place of effective management is in Malta. As noted, such a company is tax-resident in Malta but not domiciled in Malta and is subject to Malta tax on Malta source income and gains and on foreign income received in Malta. Any foreign source capital gains are not subject to Malta tax even if received in Malta.

Foreign investments of a local target company

Malta does not have any controlled foreign company legislation.

Comparison of asset and share purchases

Advantages of asset purchases

- An unrelated buyer can claim tax depreciation and other tax deductions based on the cost at which the assets were acquired. Such assets may include intangible assets generated by the seller that would not be recorded on the books of the target.
- An asset purchase is ideal when only part of a business is to be acquired or when non-core business and assets are not to be acquired, thus avoiding a split of the target prior to a share purchase deal.
- In an asset purchase deal, the buyer does not acquire the target along with its liabilities and obligations, some of which could be unknown or contingent.
- Interest incurred to finance an asset purchase is deductible against the operating income generated from the business/assets acquired, thus avoiding the need for debt pushdown planning at a later stage.
- A step-up in the cost base of assets for tax purposes is obtained.

Disadvantages of asset purchases

- Possible need to renegotiate supply, employment and technology agreements.
- A higher capital outlay is usually involved (unless debts of the business are also assumed).
- Unutilized tax losses and depreciation are not taken over.
- Where an asset purchase deal results in higher tax for the seller, the purchase price may be higher.
- Buyer may need to reapply for licenses.
- Higher transfer duties may apply, especially where real estate is involved.

Advantages of share purchases

- Possibility of participation exemption and capital gains exemption for non-resident seller, so probably more attractive for the seller even from a commercial perspective.
- Possibility of exemption from transfer/document duty.
- Usually involves a lower capital outlay (purchase of net assets only).

— Buyer normally benefits from unutilized tax depreciation and tax losses.

— Contractual continuity since there is only a shareholding change in the target; avoids need to renegotiate contracts.

Disadvantages of share purchases

— Buyer effectively becomes liable for any claims or previous liabilities of the entity (including tax).

— Buyer misses out on potentially higher depreciable asset values in an asset purchase deal.

— If debt-financed, interest expense is not immediately deductible against operating profits of target but only against dividends with the right of refund of the underlying tax, creating a cash flow disadvantage and thus a need for debt pushdown strategies (e.g. merger of target with acquisition company).

— Where an exemption from transfer and document duty is not available, additional duty on the value of the shares may be incurred.

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The Netherlands

Introduction

The Dutch tax environment for cross-border mergers and acquisitions (M&A) has undergone some fundamental changes in recent years.

These changes affect fundamental decisions that a prospective buyer will face:

— What should be acquired: the target's shares, or its assets?

— What will be the acquisition vehicle?

— How should the acquisition vehicle be financed?

Recent developments

This summary of recent Dutch tax developments is based on current tax legislation up to and including the Tax Plan 2018, which was announced in September 2017 and took effect as of 1 January 2018. This summary also discusses government plans based on statements as announced in the coalition agreement of the new Dutch government presented in October 2017.

Dividend withholding obligation cooperative

On 1 January 2018, the 'Withholding obligation for holding cooperatives and expansion of the withholding exemption Act' (the 'Act') took effect.

Until 2018, profit distributions from cooperatives were generally exempt from dividend withholding tax (WHT). Based on the new Act, dividend WHT is also levied on distributions made by holding cooperatives, where they have qualifying membership right holders (generally members owning an interest of at least 5 percent in the cooperative). A 'holding cooperative' is defined as a cooperative whose actual activity in the preceding year consisted primarily (70 percent or more) of the holding of participations or the direct or indirect financing of related entities or individuals.

A holding company with more than 70 percent of participations on its balance sheet is not regarded as a holding cooperative where it actively holds these participations, employs staff and performs other head office functions.

Under certain circumstances, a cooperative used in a private equity structure where the total assets on the balance sheet consist of more than 70 percent of participations may be 'disregarded' as a holding cooperative based on other factors, such as number of employees, office space and active involvement in the business of the participations.

Expansion of dividend withholding exemption

The new Act also extends the dividend WHT exemption. Normally, dividend distributions by a Dutch company are subject to 15 percent dividend WHT but an exemption may apply in certain circumstances. The exemption is extended not only for cooperatives but also for any company or other entity subject to dividend WHT. As of 1 January 2018, the WHT exemption applies for distributions where the recipient to the distribution is established in a state that has a tax treaty with the Netherlands containing a dividend provision and owns a qualifying interest in the Dutch company.

The new WHT exemption includes an anti-abuse provision. In short, this provision applies where the interest in the company or holding company established in the Netherlands is held for the principal purpose of, or one of the-principal purposes of, avoiding dividend WHT being levied on another party (subjective test) and the arrangement is an artificial structure or transaction (objective test).

The subjective test assesses whether less dividend WHT is payable by the taxpayer by interposing the direct shareholder of the Dutch entity (the 'disregard principle'). If not, then there will be no avoidance of dividend WHT for another party.

The objective test assesses whether a structure is set up on the basis of valid commercial reasons that reflect economic reality. If not, the exemption may not apply. Valid commercial reasons are present, for example, where the entity holding the interest carries on a business and the interest in the Dutch company is a functional part of the business assets of that entity, and also where the shareholder fulfills a linking function and has relevant substance. There is relevant substance if the intermediate holding company cumulatively meets a number of conditions in the country where it is established. Among others, these conditions include a payroll expense criterion of at least 100,000 euros (EUR) (which must be a fee for the linking function activities) and a requirement that during a period of at least 24 months, the company must have its own office equipped with the usual facilities for performing holding activities. If the interest in the Dutch company is held by a hybrid entity, then specific provisions apply for purposes of the WHT exemption.

Changes in foreign substantial interest rules

The new Act aligns the current national anti-abuse provisions with EU law and treaty anti-abuse provisions. In the future, the foreign substantial interest rules for corporate income tax would only apply where the taxpayer holds the substantial interest for the primary purpose of, or one of the primary purposes of, avoiding personal income tax at another party. The deduction of costs is possible. Tax is levied at the corporate income tax rate (20–25 percent). Any withheld dividend WHT can be deducted.

Tax aspects of the coalition agreement

On 10 October 2017, the new Dutch government coalition presented the result of their coalition negotiations. The agreement in principle covers 2017 to 2021 and includes a number of plans relative to the Dutch tax system. The most relevant plans are as follows:

— Corporate income tax will be incrementally reduced. As of 2019, both corporate income tax rates will be reduced in three steps by a total of 4 percent. The normal rate of 25 percent will drop to 21 percent in 2021 and the reduced rate of 20 percent (on taxable profits up to EUR200,000) will be reduced to 16 percent in 2021.

— For corporate income tax purposes, a loss can currently be set off against the profit of the preceding year ('carry back') and the nine following years ('carry forward'). The carry-forward term will be limited to 6 years. This change is intended to take effect as of 2019.

— The new Cabinet intends to abolish Dutch dividend WHT, except for abusive situations and distributions to low-tax jurisdictions. Although the coalition agreement does not state when this will take effect, underlying documents suggest the WHT will be eliminated as of 2020.

— In addition to the proposed (partial) elimination of dividend WHT, a WHT on interest and royalty payments to low-tax jurisdictions will be introduced for 'letterbox constructions'. The coalition agreement indicates this WHT would be introduced as of 2023.

Implementation of the Anti-Tax Avoidance Directive

On 10 July 2017, a document for internet consultation was published describing the planned introduction or amendment of a number of tax provisions following the requirement for the Dutch government to transpose the European Anti-Tax Avoidance Directive (ATAD) in its domestic tax laws. For some of these measures, actual legislation has been proposed in the meantime. The ATAD requires the Netherlands to implement five measures against the avoidance of corporate income tax:

1. limits on the deductibility of interest by way of earnings-stripping rules (described below)
2. exit tax rules
3. a general anti-abuse rule (GAAR)
4. rules for foreign companies and permanent establishments (controlled foreign companies — CFC; described below)
5. a measure against hybrid mismatches (hybrid entities and hybrid financing).

The consultation document only covered the first, second and fourth set of measures. The third measure has not led to a proposal for additional legislation because the Cabinet believes this measure is already in place through the abuse of law doctrine (*fraus legis*). The fifth measure does not have to be implemented until the end of 2019 (unlike the first four that must be implemented in principle by 1 January 2019) and is deferred pending an internet consultation.

Earnings-stripping rule

Under the earnings-stripping rule, as of 2019, interest is no longer deductible insofar as the balance of payable and receivable group and third party interest exceeds 30 percent earnings before interest, taxes, depreciation and amortization (EBITDA). The new Cabinet has opted for a threshold of EUR1 million in interest. The new legislation will not include the possibility of a group escape offered by the ATAD. Some existing specific interest deduction limitations will be abolished (except for the specific interest deduction limitation targeting base erosion).

Because banks usually receive net interest, the earnings-stripping rule is not expected to affect them. However, a thin capitalization rule is being introduced for banks and insurers, which will limit the interest deduction on debt exceeding 92 percent of the balance sheet total for accounting purposes.

Controlled foreign companies

As of 2019, a CFC measure will apply to a taxpayer's controlled entities and permanent establishments. A controlled entity exists where the taxpayer, whether or not together with an affiliated entity or affiliated individual (with a 25 percent affiliation criterion applying), directly or indirectly has an interest of more than 50 percent (based on nominal paid-in capital, statutory voting rights or profit) in the respective entity. To be regarded as a controlled entity requires that the particular entity is not subject to a profit tax that is fair according to Dutch standards. Broadly, a tax rate of less than 12.5 percent on the taxable profit determined according to Dutch standards is not considered as a sufficient tax.

When applying the rule, the type of income received by the controlled entity should be considered. The CFC rule may apply where the income of the controlled entity comprises interest, royalties, dividends, capital gains on shares, benefits derived from financial leasing, benefits derived from insurance, banking or other financial activities or specific invoicing activities ('tainted benefits').

The tainted benefits derived by the controlled entity (to the extent not distributed by the controlled entity before the taxpayer's year-end) are allocated to the taxpayer, becoming part of its Dutch profit. This allocation should also take place where the controlled entity is part of a chain of companies where, at the taxpayer's level, the participation exemption applies to the first link in the chain (e.g. on the basis of the intention test, subject-to-tax test or assets test).

In accordance with ATAD 1, the CFC measure would not apply where 70 percent or more of the benefits received by the controlled entity or permanent establishment consist of benefits other than tainted benefits or a regulated financial institution is involved (provided certain conditions are met). The measure would also not apply insofar as the controlled entity performs a significant economic activity, supported by staff, equipment, assets and premises.

The Netherlands chose not to use the option in ATAD 1 to limit this exception to European Union (EU) and European Economic Area (EEA) situations. Accompanying measures are proposed for the interaction with the participation exemption and for tax credits granted for foreign tax levied on a controlled entity or permanent establishment.

Multilateral Instrument

The Netherlands has signed the Multilateral Convention to implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (BEPS) and improve dispute resolution mechanisms, also referred to as the Multilateral Instrument (MLI).

The MLI is designed as a quick and effective mechanism to allow governments to bring their treaties in line with recommendations arising from the Organisation for Economic Co-operation and Development's (OECD) BEPS project, instead of renegotiating individual treaties.

The convention will implement minimum standards to counter treaty abuse (BEPS Action 6) and to improve dispute resolution mechanisms (BEPS Action 14). Jurisdictions can choose to implement optional provisions of the MLI, which will come into force in bilateral relations where there is a 'match' in the choices made by the treaty partners. To what extent tax treaties will be amended by the MLI depends on these matches.

The MLI will have effect for bilateral tax treaties that are listed by both participating jurisdictions, after both partners have ratified the MLI domestically and the MLI waiting periods have expired. The date on which the MLI applies to a specific tax treaty depends on the two jurisdictions involved and when they adopt the MLI.

The MLI does not override or amend existing bilateral tax treaties, as an amending protocol does. Rather, the MLI applies alongside the covered tax agreements, modifying their application in order to implement BEPS measures. On signing the MLI , the Netherlands opted for a principal purposes test (PPT) to counter treaty abuse. The PPT denies treaty benefits where it is reasonable to conclude that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless granting that benefit in the circumstances would meet the object and purpose of the relevant treaty provisions.

The Netherlands' ratification procedure is expected to be completed during 2018 and the MLI expected to take effect as of 1 January 2019.

EU Court of Justice ruling on "per element approach"

On 22 February 2018, the Court of Justice of the European Union (CJEU) rendered judgment in two corporate income tax cases for which the Dutch Supreme Court had requested preliminary rulings.[1] The CJEU joined both cases as they have a common key issue: whether taxpayers, despite being unable to enter into a fiscal unity with subsidiaries established elsewhere in the EU, are still eligible for benefits from separate elements of the fiscal unity regime as if the foreign subsidiaries could enter a fiscal unity (the 'per element' approach).

In one case concerning an interest deduction limitation (profit shifting, Section 10a Corporate Income Tax Act 1969), the CJEU ruled that the limitation is contrary to the freedom of establishment. In response to the Advocate General's opinion, the Dutch Cabinet had already announced emergency remedial measures that would be implemented with retroactive effect to 11:00 a.m. on October 25, 2017, should the CJEU follow the Advocate General's opinion.

As a result, some corporate income tax and dividend WHT rules — even in domestic relationships — will have to be applied as if there is no fiscal unity. Based on a letter by the Deputy Minister of Finance also published on 22 February 2018, a draft bill should be presented to the Lower House in the second quarter of 2018.

Asset purchase or share purchase

Generally, from a seller's perspective, a sale of assets is likely to generate a taxable gain or loss unless tax relief applies or the gain can be deferred by creating a reinvestment reserve. This reserve operates by way of a rollover, so that the gain on the sale of one business asset can be used to reduce the tax basis of another business asset or assets. The relief is subject to various conditions, including a proven intent to reinvest in

[1] For details, see the memorandum from KPMG in the Netherlands at: https://meijburg.com/news/important-judgments-for-corporate-income-tax-supreme-court-requests-preliminary-rulings-from-the-cjeu-on-the-per-element-approach

a 3-year reinvestment period and, in some cases, the type of new asset.

Where shares or assets are acquired from an associated party at a price that is not at arm's length, a deemed dividend distribution or capital contribution may result.

Capital gains realized on the sale of shares qualifying for the participation exemption are tax-exempt. For details, see 'Purchase of shares' later in this report.

Purchase of assets

When a Dutch company acquires assets, the assets are reported in the acquiring company's financial statements in accordance with generally accepted accounting principles (GAAP).

Any financing costs relating to the acquisition of assets are generally deductible on an accruals basis for Dutch corporate income tax purposes. See, however, the restrictions discussed in 'Choice of acquisition funding' later in this report.

The transfer of Dutch real estate may be subject to transfer tax at a rate of 6 percent.

Generally, any resulting gain (sometimes referred to as tax on hidden, i.e. untaxed, reserves) on the sale or other transfer of assets by a Dutch-resident company (or a non-resident company that holds the assets through a Dutch permanent establishment) is subject to Dutch corporate income tax, unless the transaction qualifies for relief as a business merger, legal merger or demerger (division). Corporate reorganizations involving simple transfers of assets and liabilities between companies forming a fiscal unity for corporate income tax purposes are generally tax-exempt, as are transfers of any other assets or liabilities within a fiscal unity (although claw-backs may apply). See 'Group relief/consolidation'.

A business merger essentially involves the transfer of a business (or independent part thereof) by one company to another company in exchange for the issue of new shares to the transferor. The relief consists of an exemption from tax for the transferor and a rollover of the transferor's existing tax basis in the transferred assets and liabilities to the acquiring company, effectively deferring any gain.

In principle, the relief is not restricted to resident companies or companies incorporated under Dutch law. In practice, the involvement of non-resident companies does have implications (described later).

The relief applies automatically where certain conditions are met (e.g. ensuring that avoidance opportunities are not present). In other cases, the relief must be specifically requested and may be granted subject to additional conditions. The relief does not apply where the merger is primarily aimed at avoiding or deferring taxation, as would generally be the case if the merger was not performed for business reasons. A business merger is deemed to have been performed for non-business reasons where shares of a company involved in a business merger are sold within 3 years after the date of the merger (subject to counterproof). Advance certainty (in the form of an advance tax ruling) can be obtained from the Dutch Revenue.

Generally, the transferor's pre-merger losses may not be transferred to the acquiring company, and the acquiring company's post-merger losses may not be carried back to be set off against the transferor's profits. However, an exception to this rule, subject to conditions and a request being filed, is made where a Dutch permanent establishment is converted into a private limited liability company (*Besloten Vennootschap* — BV) or public limited liability company (*Naamloze Vennootschap* — NV) by way of a business-merger.

In a legal merger, the assets and liabilities of one or more companies are transferred to another new or existing company, and the transferor(s) then cease(s) to exist. As a rule, the acquiring company issues new shares to the shareholder(s) in the transferor(s) in exchange for the transfer.

The tax relief available for a legal merger consists of an exemption from tax for the transferor and a rollover of the transferor's existing tax basis in the transferred assets and liabilities, as well as fiscal reserves, to the acquiring company, effectively deferring any gain. A legal merger may involve non-Dutch companies, subject to conditions. Generally, the tax relief is not restricted to resident companies but also applies to companies resident in the EU. A Dutch NV can also merge with similar entities from other EU member states to form a new societas Europaea (SE).

A similar procedure to that of business mergers is available for obtaining the relief and advance certainty. The transferor's pre-merger losses may be transferred to the acquiring company, and the acquiring company's post-merger losses may be carried back to be set off against the transferor's profits, provided a request is filed and applicable conditions are satisfied.

There are two basic forms of demerger (division) under Dutch civil law. The first generally results in the division of a company's business between two or more acquiring companies, with the transferor ceasing to exist (pure demerger). The second involves a transfer of all or part of a company's business to one or more new or existing companies, but the company continues to exist (split-off). In both cases, new shares are issued in exchange for the transfer. Typically, the acquiring company issues the new shares to the shareholders in the transferor. The tax relief applies in the same way as for legal mergers. A similar procedure to that of asset mergers is available for obtaining the relief and advanced certainty.

For a pure demerger, pre-demerger losses can be carried forward and post-demerger losses carried back, as is the case for legal mergers. However, for a legal merger, a request must

be filed with the Dutch tax authorities. For a split-off, losses may only be transferred to the acquiring entity subject to certain conditions, including that the demerging entity ceases to be a taxpayer in the Netherlands. The tax losses available for carry forward and carry back then remain available at the level of the company that continues to exist.

For a legal merger and legal demerger involving an acquisition company that has been debt-funded, the interest deduction limitation rule applies in the same way as for acquisition holding companies that have been included in fiscal unities. See 'Choice of acquisition funding'.

Purchase price

Acquisition prices from affiliated parties may be challenged under transfer pricing rules. There are no particular rules for allocating the purchase price between the assets acquired, other than using the fair market value for each of the assets acquired.

Goodwill

Goodwill is reported in the acquiring company's financial statements for financial reporting and tax purposes as the difference between the value of the acquired assets and the price paid. The maximum annual amortization of goodwill for tax purposes is 10 percent of the acquisition or development costs. Under a merger or demerger where tax relief is granted, any goodwill recognized for accounting purposes as a result of purchase price accounting is not tax-deductible.

Depreciation

Depreciation is available on the acquired assets that are necessary for carrying on the business, provided that their value diminishes over time. Maximum annual amortization and depreciation percentages apply to goodwill (10 percent) and business assets other than goodwill and real estate (20 percent).

Depreciation of real estate is possible until a residual value is reached. For investment properties, the minimum residual value equals the value established by the municipality under the Valuation of Immovable Property Act (WOZ). For properties used as part of one's own business (such as the business premises), the residual value is half the value determined under the WOZ. Under the new depreciation system, it continues to be possible to record impairment to buildings at a lower going-concern value.

Accelerated amortization/depreciation is possible in respect of qualifying environmental assets.

Tax attributes

Tax losses are not transferred on an asset acquisition. They remain with the company. However, an exception to this rule is made for qualifying mergers or divisions, and where a Dutch permanent establishment is converted into a BV or an NV by way of an asset merger or split-off. In the latter cases, where the transferor is no longer subject to Dutch tax after the transaction, a request may be submitted to allow a carry forward or carry back of losses, subject to the losses being offset against the profits attributable to the assets that generated the losses.

The transfer of assets within a fiscal unity does not generally affect tax attributes, so the transfer does not, for example, result in taxable gains. A claw-back may apply where the fiscal unity is dissolved within 6 years after the transfer.

Value added tax

Valued added tax (VAT) is the most important indirect tax in the Netherlands.

Dutch VAT is levied on the net invoiced amount charged by businesses for supplies of goods and services taxable within the Netherlands. Businesses are only allowed to reclaim the input VAT on their investments and costs attributable to:

— activities subject to VAT

— VAT-exempt financial services rendered to non-EU persons and to non-EU permanent establishments.

Input VAT can only be recovered where the business is the actual recipient of the services and a correct invoice is issued to this business.

No VAT is due when all or an independent part of a company's business is transferred and the transferred business continues as before (also known as transfer of a business as going concern). These transactions are out of scope for VAT purposes. This relief also applies to legal mergers but not to the sale of single assets or trading stock (e.g. inventory).

Where the buyer in a merger or share acquisition transaction wishes to reclaim VAT on the transaction costs, the buyer should always ensure it has activities subject to VAT or provides VAT-exempt financial services to non-EU parties. The post-deal VAT recovery position depends largely on the facts and circumstances of the proposed structure.

Transfer taxes

A real estate transfer tax at the rate of 6 percent (2 percent on residential real estate) of the real estate value (which must equal at least the purchase price) is due on all transfers of titles to Dutch real estate. This tax also applies to shares in Dutch real estate companies, provided the buyer holds at least one-third of the economic interest in the real estate company. A company is considered as a real estate company if the assets (at fair market value) consist of more than 50 percent real estate. Real estate located outside the Netherlands is included, provided the assets consist of at least 30 percent real estate located in the Netherlands (asset test). If the asset test is met, then the actual activities must be assessed to determine whether at least 70 percent of these activities involve the exploitation of this real estate (e.g. investment).

The transferee is liable for the tax, but the contract may stipulate that the transferor will bear the expense.

Purchase of shares

Shares in a company generally are acquired through a purchase or exchange of shares. In principle, the acquisition of shares is capitalized in the acquiring company's financial statements.

In practice, shares that are held as a shareholding qualifying for the participation exemption (discussed later) are carried at cost for tax purposes; this is only relevant for specific purposes, given that a disposal of such a shareholding is tax-exempt. Costs directly related to such acquisitions are generally not deductible. Costs related to obtaining debt-financing may be deducted if and to the extent that interest on acquisition loans is tax-deductible.

Shares held as a portfolio investment are generally carried at cost or market value, whichever is lower. Specific regulations apply to a participation of 25 percent or more in a low-taxed investment company (i.e. generally, 90 percent or more of its assets comprise passive investments and are subject to tax at a rate lower than 10 percent).

Where shares in a Dutch target are acquired in exchange for new shares issued by a Dutch company, as in a share-for-share exchange, the new shares are only treated as paid-up to the same extent that the target's shares were paid-up. In effect, the potential dividend WHT that would have been due on profit distributions by the target is shifted to the acquiring company, as and when it distributes profits. To mitigate the impact of this rule, concessionary treatment applies when a Dutch company acquires a foreign target.

In certain circumstances, a change in ownership of shares in a Dutch company may result in the company losing its right to carry forward losses (discussed later).

Where the price the buyer pays for the shares is higher than the book value of the underlying assets of the acquired company, the basis of the company's underlying assets may not be stepped up to the price paid for the shares and the excess cannot be treated as payment for amortizable goodwill. Goodwill paid on a share acquisition is not tax-deductible for the buyer or the target (on the basis of purchase price accounting).

The acquisition or transfer of shares is exempt from VAT. An important issue is often the extent to which a business is entitled to reclaim the Dutch VAT levied on its transaction costs for the sale of shares of a subsidiary (generally not taxed for VAT purposes) to an EU-based buyer. VAT levied on costs attributable to an asset transaction and a statutory merger generally can be recovered by the seller on a pro rata basis. Under a special decree for majority shareholdings, the VAT on costs attributable to their sale is generally fully reclaimable.

The transfer of shares in a company owning real estate may be subject to transfer tax at a rate of 6 percent. A company is considered to be a real estate company where its assets (at fair market value) consist of more than 50 percent real estate. Real estate located outside the Netherlands is included, provided that the assets consist of at least 30 percent real estate located in the Netherlands (asset test). Where the asset test is met, then the actual activities must be assessed to determine whether at least 70 percent of these activities involve the exploitation of this real estate (e.g. investment).

The acquisition of shares is not subject to capital contribution tax, other indirect taxes or local or state taxes.

The sale of a shareholding that qualifies for the participation exemption (as described later) is exempt from tax. A loss is accordingly non-deductible. Costs directly relating to the sale of a qualifying participation are also non-deductible. There is no minimum holding period.

In principle, the participation exemption applies to shareholdings in Dutch or non-Dutch companies of at least 5 percent unless the subsidiary can be considered to be held as a passive investment (motive test). A subsidiary is considered to be held as a passive investment if the taxpayer's objective is to generate a return that may be expected from normal active asset management. Where more than 50 percent of the subsidiary's assets comprise shareholdings in companies representing an interest of less than 5 percent or where the subsidiary's main function is to provide group financing, such subsidiary is also considered to be held as a passive investment.

A subsidiary that is considered as a passive investment may still qualify for the participation exemption where one of two conditions are met:

— Less than 50 percent of the fair market value of the assets (on a special consolidated basis) comprise non-business-related, low-taxed investments (asset test).

— The company is taxed at a reasonable tax rate (10 percent or more) based on Dutch tax principles (subject to tax test).

Generally, assets held by subsidiaries are taken into account for the asset test. The relevant entity's activities determine whether an asset qualifies as a non-business-related investment, which is an investment that cannot reasonably be considered necessary for the business operations of the entity holding these investments. The question of whether investments qualify as non-business-related should be answered case-by-case. If the participation exemption applies, WHT on any received dividends cannot be credited.

As a result of changes to the EU Parent-Subsidiary Directive, the Dutch participation exemption does not apply to payments received from or made by the participation insofar as the

participation can deduct these for profit tax purposes (a hybrid mismatch). The participation exemption therefore no longer applies if a shareholder, for example, receives a dividend and this dividend is deductible by the participation. Benefits derived from the disposal of the participation and foreign exchange results remain exempt in principle, given that they are non-deductible at the level of the participation.

Complex temporal ring-fencing rules deal with situations where the participation exemption does not apply to the entire period that the shareholding has been held. In the past, Supreme Court case law on temporal ring-fencing dealt with situations where the participation exemption became applicable or no longer applied to an existing shareholding (exemption transition) as a result of a change in the facts. In short, case law on temporal ring-fencing meant that the tax treatment of capital gains realized after such a change was determined on the basis of the tax regime applicable during the shareholding period to which the benefit could be attributed.

According to the legislation, temporal ring-fencing must take place either when there is a transition in qualification for the participation exemption as a result of a change in the facts or when legislation is amended, both in relation to dividends and capital gains. The bill will replace existing Supreme Court case law and applies to all types of exemption transitions in respect of a shareholding. The legislation has substantial retroactive effect as benefits of the participation exemption received in the distant past may as yet be reclaimed.

Tax indemnities and warranties

In a share acquisition, the buyer takes over the target company together with all related liabilities, including contingent liabilities. Therefore, the buyer normally requires more extensive indemnities and warranties than in the case of an asset acquisition.

Tax losses

Generally, tax losses may be carried forward for 9 years-and carried back for 1 year within the same company or fiscal unity. However, the carryover may be restricted or denied in circumstances involving a change of 30 percent or more in the ownership of the company where the company has primarily held passive investments during the years concerned or its business activities have significantly (70 percent or more) decreased. The carry forward of prior-year losses by a holding and finance company may also be restricted, as may the carry back of losses.

According to legislation, a company is a holding and finance company where 90 percent or more of its activities, for 90 percent or more of the financial year, comprise holding participations and/or the financing of affiliated companies. The losses incurred by such companies may only be set off against profits where the company also qualifies as a holding and finance company in the profitable year and where the net amount of affiliated loan receivables is not greater in the profitable year or if the net amount is greater, then this was not primarily done to take advantage of the loss set-off.

The existing rules for setting off losses within a fiscal unity are extensive, but the normal time limits for such set-off still apply. Generally, pre-fiscal unity losses can be set off only where the fiscal unity as a whole has a profit for tax purposes after setting off the results of the various fiscal unity companies. Thereafter, the total result of the fiscal unity is divided into the parts attributable to the participating companies in the fiscal unity. If the individual participating company still shows a profit, only the pre-fiscal unity losses of that company may be set off against that profit.

The same procedure is followed for carrying back the loss incurred by a fiscal unity company to be set off against its pre-fiscal unity profits. Other specific rules apply to the treatment of losses and foreign tax credits after a fiscal unity is dissolved or when a company leaves a fiscal unity.

Crystallization of tax charges

A tax charge does not arise on a share transfer if the transfer qualifies as a share-for-share merger. This essentially involves an exchange of shares in the target company for shares in the acquiring company. The relief consists of an exemption from tax for the transferor and a rollover of the transferor's existing tax basis in the target shares into consideration shares in the acquiring company, effectively deferring any gain.

This relief is available where:

- A company resident in the Netherlands:
  - acquires, in exchange for the issue of shares in its own capital (or profit rights), shares in another company resident in the Netherlands
  - can exercise more than 50 percent of the voting rights in the latter company after the acquisition.
- A qualifying company resident in an EU member state:
  - acquires, in exchange for the issue of shares in its own capital (or profit rights), shares in a qualifying company resident in another EU member state
  - can exercise more than 50 percent of the voting rights in the latter company after the acquisition.
- A company resident in the Netherlands:
  - acquires, in exchange for the issue of shares in its own capital (or profit rights), shares in a company resident outside the EU
  - can exercise at least 90 percent of the voting rights in the latter company after the acquisition.

A cash payment of up to 10 percent of the nominal value of the shares issued under the share-for-share merger is permitted for rounding purposes (but the relief is limited to the share based element).

Relief is not available where the transaction is primarily aimed at avoiding or deferring taxation. Unless the taxpayer can demonstrate otherwise, this motive is presumed where the transaction does not take place for sound business reasons, such as a restructuring or rationalization of the activities of the companies involved. Before carrying out the transaction, the taxpayer can request confirmation from the Dutch tax authorities that it will not deny relief on these grounds.

For corporate taxpayers, the importance of the share merger facility is limited by the broad scope of the participation exemption. Moreover, although the share-for-share merger facility also applies for personal income tax purposes where Dutch individual shareholders are involved, the importance of the facility generally is limited to those owning at least 5 percent of the target (i.e. holders of substantial interests), as gains on smaller shareholdings are not usually taxable.

The disposal outside a fiscal unity (see 'Group relief/ consolidation') of a subsidiary that has been involved in the transfer of assets within the fiscal unity in the preceding 6 years may give rise to a tax liability from the previously transferred assets. Under certain conditions, this period may be limited to 3 years. The transferred assets are revalued at market value prior to the fiscal unity being terminated. An exception is made where the transfer of the assets is part of the normal businesses of both companies.

Once a company has left a fiscal unity, it remains jointly and severally liable for taxes payable by the parent company of the fiscal unity (both corporate income tax and VAT fiscal unity) and allocable to the tax periods in which the company was included in the fiscal unity. This liability arises pursuant to the Dutch Tax Collection Act and should be addressed in the sale-purchase agreement.

Pre-sale dividend

The participation exemption applies to a pre-sale dividend, provided it meets the applicable conditions and the seller is a Dutch resident. Where the seller is non-resident, the relevant treaty or the applicable domestic type of relief determines whether the Netherlands will withhold tax on the paid dividend.

Transfer taxes

A 6 percent real estate transfer tax is due on all share transfers in Dutch real estate companies. A company is considered to be a real estate company if its assets (at fair market value) consist of more than 50 percent real estate. Real estate located outside the Netherlands is included, provided that the assets consist of at least 30 percent real estate located in the Netherlands (asset test). If the asset test is met, then the actual activities should be assessed to determine whether at least 70 percent of the activities involve the exploitation of this real estate (e.g. investment).

Tax clearances

See 'Crystallization of tax charges' earlier in this report.

Choice of acquisition vehicle

Several potential acquisition vehicles are available to a foreign buyer for acquiring the shares or assets of a Dutch target. Tax factors often influence the choice of vehicle.

Local holding company

Dutch tax law and the Dutch Civil Code contain no specific rules on holding companies. In principle, all resident companies can benefit from the participation exemption if they satisfy the relevant conditions (see purchase of shares). Under the participation exemption, capital gains and dividends from qualifying shareholdings are exempt from corporate income tax. However, legislation limits the possibility of setting off losses that are incurred by holding and finance companies against profits (again, see the section purchase of shares).

In principle, therefore, a buyer already active in the Netherlands through a subsidiary or branch could have that entity make a qualifying share acquisition. In practice, a special-purpose company is often incorporated in the Netherlands for the purposes of such acquisitions. The main types of Dutch corporate entities are the BV, the NV and the Dutch cooperative.

For Dutch tax purposes, there are no material differences between the types of entities. Dividend distributions made by cooperatives are not subject to dividend WHT, unless the entity qualifies as a 'holding cooperative, defined as a cooperative whose actual activity in the preceding year generally consisted primarily (70 percent or more) of holding participations or directly or indirectly financing related entities or individuals.

In principle, funding costs, such as interest incurred by a local holding company, can be deducted from the taxable profit of the acquiring company. Restrictions apply for the deduction of interest from the taxable profit of the target if a fiscal unity is formed. See the section on choice of acquisition funding earlier in this report.

Foreign parent company

The foreign buyer may choose to make the acquisition itself. As a non-resident without a Dutch permanent establishment, the foreign buyer is not normally exposed to Dutch taxation in respect of the shareholding, except for possible WHT on dividends, or if the non-resident taxation rules would apply. Dutch WHT on dividends is 15 percent unless reduced by a treaty or a domestic exemption applies. Dividends to foreign

EU-based corporate shareholders holding at least 5 percent of the shares normally qualify for an exemption from WHT. See 'Recent developments' for discussion of a recent extension of the WHT exemption.

Non-resident intermediate holding company

Due to the Netherlands' extensive network of tax treaties, there is often no benefit to interposing a treaty country intermediary. However, where the buyer is resident in a non-treaty country, the dividend WHT may be reduced by interposing a Dutch cooperative (if not considered as a holding cooperative) or a foreign holding company resident in a treaty country between the buyer and the target company. Consideration should be given to the new Dutch domestic anti-abuse provisions and the MLI (see 'Recent developments').

Local branch

A branch of a foreign company is subject to Dutch corporate income tax in the same way as a domestic company. In principle, non-resident entities that have Dutch permanent establishments to which qualifying shareholdings can be attributed can benefit from the participation exemption. In principle, funding costs, such as interest incurred by a local branch, can be deducted in computing the taxable profits of the target if a fiscal unity can be formed after the acquisition (see 'Group relief/consolidation' later in this report). No WHT is levied on distributions to the foreign head office, which can be an advantage when acquiring a Dutch target's assets. If the deal is properly structured, using a branch to acquire shares in a Dutch target also offers the possibility of distributing profits free from WHT. A negative commercial aspect of using a branch is that the branch may not be considered a separate legal entity, fully exposing the head office to the branch's liabilities. Additionally, the Dutch tax authorities generally deny a deduction for interest charged by the head office unless the deduction relates to external loans.

Joint venture

Joint ventures can be either incorporated (with the joint venture partners holding shares in a Dutch company) or unincorporated (usually a limited partnership). A partnership may be considered transparent for Dutch tax purposes, if certain conditions are met. In this case, the partnership's losses can be offset against the partners' profits. However, selling the business may lead to taxable profit at the level of the partners. Due to the participation exemption, where the conditions are met, the profit or loss on the sale of the shares of a tax-transparent partnership do not lead to taxable profit.

Choice of acquisition funding

Debt

Interest expenses on both third-party and related-party debt are generally deductible on an accruals basis for Dutch corporate income tax purposes. This also applies to interest qualifying for the participation exemption, regardless of whether the shareholding is in a resident or non-resident company, unless a specific restriction on the deductibility of interest applies.

Deductibility of interest

Specific restrictions on deducting interest expenses (including costs and foreign exchange results) apply for interest paid to affiliated companies and individuals where the loan is used for the acquisition of shares in companies that, after the acquisition, become affiliated with the buyer as a consequence of such acquisition. Certain guarantees by affiliated companies and individuals may qualify a third-party loan as a loan by these affiliated companies or individuals.

These restrictions do not apply where the taxpayer shows that both the transaction and the related debt were predominately motivated by sound business reasons (double business motivation test) or where the recipient of the interest (or, for a conduit company, the ultimate recipient) is subject to effective taxation at a rate that is considered reasonable according to Dutch standards (generally, 10 percent or more, computed under Dutch corporate income tax principles). In the latter case, the restrictions still apply where the Dutch tax authorities can show that the transaction and the related debt were not both predominately motivated by sound business reasons.

Interest on a loan between affiliated entities that has no defined term or a term exceeding 10 years and carries a return of less than 70 percent of an arm's length return is not deductible.

The second main interest deduction limitation rule applies to excessive deduction of interest related to the financing of participations (participation debt). The non-deductible amount of interest is calculated by dividing the excessive amount of participation debt by the total amount of debt and multiplying this by the total amount of interest paid. The excessive participation debt is calculated as the value of the participations for tax purposes (historic cost price and capital contributions) less the total amount of equity for tax purposes. An exemption is provided for expansion investments, that is, investments in participations that expand a group's operating activities. The acquisition price of these participations does not have to be taken into account in calculating disallowed interest. The exemption does not apply where, for example, a double dip structure or a hybrid entity/ instrument was used to finance these participations.

Generally, no disallowed interest should arise on the basis of the excessive participation debt rules where:

— The amount of equity for tax purposes exceeds the acquisition price of the participations.

— The Dutch taxpayer has included all its participations in the fiscal unity for corporate income tax purposes (not possible for foreign participations).

— The participations of the taxpayer were all historically incorporated or acquired as an expansion of a group's operating activities, no double dip structures or hybrid entity/financing structures were implemented, and the acquisition, expansion and financing were not entered into because of the interest deduction.

— The excessive amount of 'participation debt' is less than EUR15 million (assuming an interest rate of 5 percent), due to a safe harbor amount of EUR750,000. This amount of interest is always deductible under these rules.

The deduction limitation applies to financial years starting on or after 1 January 2013. Transitional rules allow for an optional fixed amount: the taxpayer may disregard 90 percent of the acquisition price (i.e. to the extent considered as an expansion investment), without further proof, where the participation was acquired or expanded or equity was contributed to the participation during a financial year starting on or before 1 January 2006. The taxpayer must prove that, in relation to the old participations to which the 90 percent rule has been applied, no double dip structures or hybrid entity/financing structures were implemented.

The participation interest measure includes a concession for active group financing activities. Under this concession, the test for determining whether there is a participation debt and non-deductible participation interest does not take into account loans and their accompanying interest and costs to the extent that these loans relate to receivables held by the taxpayer in respect of the active group financing activities.

There is an implementation decree for internal reorganizations that is intended to avoid overkill as a result of other statutory restrictions of interest deduction.

A third main interest deduction limitation rule applies to acquisition holding companies that are debt financed where the buyer and the target enter into a fiscal unity for corporate income tax purposes. Under this restriction, acquisition debts exist where the debt is related directly or indirectly, by law or by fact, to the acquisition or expansion of a participation in one or more companies.

Interest expenses on the acquisition debt are deductible up to the amount of the buyer's own profit before deducting the acquisition interest expenses (own profit). Where the acquisition interest exceeds the own profit and the excess amount is less than EUR1 million (franchise), then the new rule does not limit the interest deduction. Where there is no excess acquisition interest (financing escape), the interest also remains fully deductible (subject to other possible limitations).

The excess acquisition interest equals the interest on the acquisition debt that exceeds a specific part of the acquisition price: 60 percent in the year in which the acquisition was included in the fiscal unity, 55 percent in the following year and so on, until a percentage of 25 percent is reached. In the case of multiple acquisition debts, particularly where they relate to companies included in the fiscal unity in different years, the excess acquisition interest must be determined for each of those years separately. Acquisition debts and acquisition prices regarding acquisitions that are included in a fiscal unity in the same year are combined.

If there is excess acquisition interest as described earlier, the non-deductible interest is limited to the lower of the following two amounts:

— acquisition interest less positive own profit minus EUR1 million

— the amount of the excess acquisition interest.

Acquisition interest that is non-deductible in any year is carried over to the following year, where it is again assessed to see if it falls under the interest deduction limitation. For the interest carried forward, the EUR1 million franchise and the financing escape are not taken into account again.

Corresponding measures apply where the target does not join the fiscal unity but a legal merger or a legal division takes place.

Complex transitional rules apply to this third restriction.

As of 1 January 2019, a new earning-stripping rule is expected to take effect. Under this rule, interest is no longer deductible insofar as the balance of payable and received group and third-party interest exceeds 30 percent of EBITDA. A threshold of EUR1 million in interest is applicable.

Some existing specific interest deduction limitations may be repealed after the earning-stripping rule is introduced.

WHT on debt and methods to reduce or eliminate it

WHT of 15 percent is levied on dividend distributions. No WHT is levied on interest (except for interest paid on hybrid loans, as described later), royalty payments or transfers of branch profits to a foreign head office. The new Dutch government has announced that WHT may be abolished as of 2020, except for abusive situations and distributions to low-tax jurisdictions.

In the absence of WHT on interest, it is often advantageous to fund a Dutch company with debt rather than equity. See, however, the restrictions on interest deduction for profit tax purposes discussed in this report's section on choice of acquisition funding. As described in 'Recent developments', the new Dutch government has announced plans to introduce a WHT on interest and royalties as of 2023. (For the dividend WHT implications of share-for-share acquisitions, see 'Purchase of shares'.)

Checklist for debt funding

- The deduction of interest may be restricted, especially where the acquisition of shares is financed with an intercompany loan.
- If the target owns subsidiaries (which are not part of the same fiscal unity), the deduction of interest may be restricted in case of excessive deduction of interest related to the financing of participations.
- If the level of the buyer's profits is not sufficient, an effective deductibility of the interest could be achieved by forming a fiscal unity within the limitations provided by the rules on acquisition holding companies described earlier.

Equity

A buyer may use equity to fund its acquisition, possibly by issuing shares to the seller in satisfaction of the consideration (share merger). Contributions to the capital of a Dutch company are not subject to capital contribution tax.

Hybrids

According to Dutch case law, a loan may be re-qualified as equity for corporate income tax purposes in the following situations:

- The parties actually intended equity to be provided (rather than a loan).
- The conditions of the loan are such that the lender effectively participates in the business of the borrowing company.
- The loan was granted under such circumstances (e.g. relating to the debtor's financial position) that, at the time the loan was granted, neither full nor partial repayment of the loan could be expected.

Pursuant to Dutch case law, loans referred to under the second bullet point above may be re-characterized as equity where:

- The term of the loan is at least 50 years.
- The debt is subordinated to all ordinary creditors.
- The remuneration is almost fully dependent on the profit.

Where a loan is re-characterized as equity under the above conditions, interest payments are non-deductible and may be deemed to be a dividend distribution, triggering 15 percent WHT (unless reduced by treaty or domestic relief).

Discounted securities

Where securities are issued at a discount, because the interest rate is below the market rate of interest, in principle, the issuer may be able to obtain a tax deduction for the discount accruing over the life of the security.

Deferred settlement

Payments pursuant to earn-out clauses that result in additional payments or refunds of the purchase price are covered by the participation exemption applicable to the relevant participations.

Similarly, the participation exemption covers payments related to indemnities or warranties to the extent that they are to be qualified as an adjustment of the purchase price.

Where settlement of a purchase price is deferred, part of the purchase price may be re-characterized as interest for tax purposes, depending on the agreed terms and the parties' intent.

Other considerations

The seller's concerns

No corporate income tax is due on share transfers, provided the conditions of the participation exemption are met. Relief from corporate income tax may be granted on a share-for-share merger, asset merger, legal merger and demerger. Where available, relief generally takes the form of an exemption for the transferor and a rollover, such that the acquired assets and liabilities retain the same tax basis they had when owned by the transferor. Certain conditions for this rollover must be met. For example, where the shares are sold within a certain period after an asset merger, the granted exemption can be revoked.

The disposal outside a fiscal unity of a subsidiary that has been involved in the transfer of assets within the fiscal unity in the preceding 6 years may give rise to a tax liability with respect to the previously transferred assets. The transferred assets are revalued at market value prior to the fiscal unity being terminated. An exception is made where the transfer of the assets is part of the normal businesses of both companies.

Company law and accounting

Under Dutch law, a company may operate in the Netherlands through an incorporated or unincorporated entity or a branch. All legal entities have to register their business with the trade registry (*Handelsregister*) at the local Chamber of Commerce (*Kamer van Koophandel*).

The most common forms of incorporated companies under Dutch commercial law are the BV and the NV. Both are legal entities and have capital stock divided into shares. As of October 2012, it is possible to issue shares without voting rights or profit entitlement. Shares of a BV are not freely transferable, which makes this type of company generally preferred as the vehicle for privately held companies. Generally, shares in an NV are freely transferable.

Foreign investment in a Dutch company does not normally require government consent. However, certain laws and regulatory rules may apply to mergers or acquisitions. In a stock merger, the shareholders of the target company either exchange their shares for those of the acquiring company or sell them to the acquiring company. The transfer of title to registered shares is made by a deed of transfer executed before a Dutch civil-law notary.

In a business merger, an enterprise is transferred to the acquiring company for cash and/or shares in the company. Such a transfer requires that all assets and liabilities be transferred separately.

In a statutory/legal merger, shareholders generally exchange their shares in the target company for those of the other (acquiring) company (or a new company); the target company is then dissolved. In addition to this basic form of statutory/legal merger, a number of variations exist, such as a merger between a parent and a subsidiary and a triangular merger under which a member of the acquiring company's group may issue the consideration shares.

Legislation on divisions and demergers/split-offs has been in force since 1998. Participants in mergers must adhere to the requirements of the Dutch takeover and merger code (*SER Fusiegedragsregels*), which protects the interests of shareholders and employees, and the Works Councils Act (*Wet op de Ondernemingsraden*), which protects the interests of employees and requires notification of mergers. Mergers of large companies that qualify as concentrations within the meaning of the Dutch Competition act must be notified to the Dutch authority for Consumers & Markets in advance.

Legislation for financial reporting is laid down in Part 9 of Book 2 of the Dutch Civil Code. Further, the Council of Annual Reporting (CAR — *Raad voor de Jaarverslaggeving*) publishes Guidelines for Annual Reporting (GAR), which is largely based on International Financial Reporting Standards (IFRS).

The financial reporting rules contain requirements about the content, analysis, classification, recognition and valuation of items in the financial statements. The statutory management of a NV or BV must prepare the financial statements within a period of 5 months. This period can be extended for up to 5 more months, with approval from the shareholders and when special circumstances apply.

Group relief/consolidation

A fiscal unity can be formed between a parent company and any companies in which it owns 95 percent of the legal and economic ownership of the nominal share capital. This 95 percent interest should represent at least 95 percent of the voting rights and should be entitled to at least 95 percent of the profits.

Firstly, a parent and the subsidiaries can be formed under Dutch law (usually as BVs, NVs or cooperatives); if they are formed under foreign law, their legal form must be comparable to a BV, NV or a cooperative.

Secondly, a company does not actually have to be resident in the Netherlands. Where the company is not a Dutch resident, it should have a permanent establishment in the Netherlands and be resident in either an EU member state or a country with a tax treaty with the Netherlands that prohibits discrimination against such a company. If the Dutch permanent establishment is the parent company of a fiscal unity, the shares in the respective subsidiaries should be attributable to the permanent establishment.

Thirdly, a fiscal unity of Dutch sister companies of an EU/EEA-resident parent company is possible, as well as between a Dutch parent company and Dutch sub-subsidiaries held through one or more EU/EEA-resident intermediate holding companies. Further, Dutch permanent establishments of EU/EEA-resident companies can be included in a fiscal unity even where the permanent establishment functions as a parent company and the shares held in its Dutch subsidiary/subsidiaries are not attributable to the permanent establishment.

A number of conditions need to be fulfilled, including identical financial years for both parent and subsidiaries. For newly incorporated companies, the start of the first financial year may deviate. A fiscal unity may be deemed to have been formed on the date requested, but the formation date cannot be more than 3 months before the date of the request.

Inclusion in a fiscal unity means that, for tax purposes, the assets and activities of the subsidiaries are attributed to the parent company. The main advantage of a fiscal unity is that the losses of one company can be set off against the profits of another in the year they arise. However, interest expense incurred in relation to the acquired company is only deductible from the profit of the parent company where the rules on acquisition holding companies described earlier permit (see also 'Choice of acquisition funding').

In addition, assets and liabilities generally can be transferred from one company to another without giving rise to tax consequences. Specific rules apply to combat the abuse of fiscal unities. In particular, the disposal outside a fiscal unity of a subsidiary that has been engaged in the transfer of assets within the fiscal unity in the preceding 6 years may give rise to a tax liability with respect to the previously transferred assets.

To ensure proper assessment and collection of tax, the Ministry of Finance has laid down a number of special conditions, in particular, extensive rules restricting a taxpayer's ability to carry forward pre-fiscal unity losses to be

set off against post-fiscal unity profits and to carry back post-fiscal unity losses to be set off against pre-fiscal unity profits.

Transfer pricing

In principle, intercompany transactions should be at arm's length for tax purposes. To provide evidence that transfer prices are at arm's length, a taxpayer must submit proper transfer pricing documentation to the Dutch tax authorities. If the Dutch tax authorities impose revised assessments, absence of such evidence may shift the burden of proof to the taxpayer (i.e. should the taxpayer wish to argue that a reasonable estimation made by the Dutch tax authoritiesis wrong). Penalties may also be imposed. Transfer pricing adjustments may entail secondary adjustments, such as hidden dividend distributions or capital contributions.

New transfer pricing documentation rules entered into force as of 1 January 2016. Companies that are part of a group with a minimum consolidated turnover of EUR750 million must notify the Dutch tax authorities by 31 December 2016 as to which group company will file a country-by-country (CbyC) report. If the fiscal year of the group starts on 1 January 2016, the group companies will need to have filed their CbyC report by 31 December 2017. Penalties may be imposed in instances of intentional non-compliance or 'serious misconduct' of the reporting entity regarding its obligation to file the CbyC report.

Further, all group entities that are tax-resident in the Netherlands and that are part of a group with a minimum consolidated turnover of EUR50 million need to maintain a master file and local file in their administration at the time of filing their tax return. Non-compliance with these documentation requirements would result in a reversal of the burden of proof.

Information obligation for service entities

In light of the national and international debate on the taxation of multinationals and developments regarding BEPS, the Cabinet introduced a measure that concerns the information obligation for service entities.

In short, 'service entities' are Dutch resident companies whose main activities involve the intragroup receipt and payment of foreign interest, royalties and rental or lease payments. A service entity can request the Dutch tax authorities to provide advance certainty on the tax consequences of proposed related-party transactions. The conditions for obtaining advance certainty are laid down in a 2004 decree. In short, these conditions provide for an actual presence in the Netherlands (i.e. substance requirements) and the real risks that must be borne as a result of the functions performed. The substance rules require, for example, that the management and administration be carried out in the Netherlands and that the amount of equity held is appropriate to the company's functions and risks.

As of 1 January 2014, these substance requirements apply to service entities, regardless of whether advance certainty was requested. They therefore apply to all service entities, which must also confirm, at the latest in their annual corporate income tax return, whether they meet these requirements.

Dual residency

In principle, a company that has been incorporated under Dutch civil law is subject to Dutch tax, regardless of whether it is also resident in another country. In certain circumstances, a Dutch company that is resident under a tax treaty in another country may be deemed non-resident for Dutch tax purposes or it may be denied certain types of relief (such as being able to join a fiscal unity).

Foreign investments of a local target company

In principle, similar rules regarding the availability of the participation exemption apply to both Dutch and non-Dutch subsidiaries. However, special rules apply to low-taxed, passive investment companies. See 'Purchase of shares'.

Comparison of asset and share purchases

Advantages of asset purchases

— All or part of the purchase price can be depreciated or amortized for tax purposes.

— A step-up in the cost basis for taxing subsequent gains is obtained.

— Generally, no previous liabilities of the company are inherited.

— No acquisition of a tax liability on retained earnings.

— Permits flexibility to acquire only part of a business.

— Greater flexibility in funding options.

— Profitable operations can be absorbed by loss-making companies in the buyer's group, thereby effectively increasing the ability to use the losses.

Disadvantages of asset purchases

— Possible need to renegotiate supply, employment and technology agreements.

— A higher capital outlay is usually involved (unless a business' debts are also assumed).

— May be unattractive to the seller, thereby increasing the price.

— Higher real estate transfer tax.

— Seller retains the benefit of any losses incurred by the target company.

Advantages of share purchases

— Lower capital outlay (purchase of net assets only).

— Likely more attractive to the seller, so the price is likely lower.

— May benefit from tax losses of target company.

— Lower real estate transfer tax.

— May benefit from the seller's ability to apply the participation exemption.

Disadvantages of share purchases

— No depreciation of purchase price.

— No step-up for taxing subsequent capital gains.

— Liable for any claims against or previous liabilities of the entity.

— No deduction for purchase price.

— Buyer inherits a potential dividend WHT liability on retained earnings that are ultimately distributed to shareholders.

— Less flexibility in funding options.

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Norway

Introduction

Norway's tax system and tax framework for cross-border mergers and acquisitions (M&A) has been relatively stable over the last years. In 2014, a Tax Commission presented a tax reform that was partly followed up in the state budget for 2016 and later years. However, the tax framework generally retains the main characteristics of the corporate income tax system before the tax reform.

As of the financial year 2014, Norway adopted legislation that sets limitations on intragroup interest. This legislation applies to limited liability companies as well as Norwegian branches of foreign companies and partnerships. The rules limit the intragroup interest deduction to 25 percent of tax-adjusted earnings before interest, taxes, depreciation and amortization (EBITDA).

The Ministry of Finance issued a public consultation paper in 2017 proposing to extend the earnings-stripping rules to interest on loans from unrelated parties, for companies that are part of a consolidated group. The State Budget for 2018 states that the amendments should be effective from 1 January 2019.

Recent developments

The most significant recent change is the proposed application of earnings-stripping rules on third party interest cost. Based on the public consultation paper, the rules offer few exemptions, which may make it difficult to claim full interest deductions in Norway on intragroup financing arrangements.

The reason for the proposal is the desire to prevent multinationals from shifting profits out of Norway to more beneficial tax jurisdictions. Two exceptions from the application of the interest limitation rules were proposed.

The first exception would apply where the equity ratio is equal to or greater than the group ratio. This exception would apply to companies that are included in a consolidated financial statement prepared under Norwegian generally accepted accounting principles (GAAP), International Financial Reporting Standards (IFRS) or the accounting rules of another member state of the European Economic Area (EEA).

The second exception was proposed for loans made in the ordinary course of business.

The rules would primarily apply when the group prepares consolidated financial statements that include the company in question. However, the rules would also apply for companies that could be included in the consolidated financial statements under IFRS. This implies that complex assessments required under IFRS would become part of Norwegian tax law, which could potentially lead to prolonged and expensive tax disputes.

As of the financial year 2019, multinational groups with operations in Norway need to consider and evaluate their current financial arrangements in light of these new rules. The arm's length principle continues to apply in addition to the interest deduction limitation rules. KPMG in Norway assumes the arm's length principle will be applied in exceptional cases since the new rules are strict; however, this remains unclear. The amendments to the Limited Companies Act and Public Limited Companies Act revise corporate governance rules, remove certain dividend constraints, and ease the ability to arrange intragroup loans from Norwegian subsidiaries to foreign group companies.

Norway signed the Organisation for Economic Co-operation and Development's (OECD) Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) on 7 June 2017. In its preliminary position on MLI, Norway included a list of 28 tax treaties that will be amended through the MLI. Norway has made partial or full reservations against several of the MLI articles.

Before entering into force, the MLI would have to be ratified by the Norwegian Parliament, but the Ministry of Finance has not yet submitted a proposal to the Norwegian parliament.

The Ministry of Finance has also proposed amendments to the domestic tax residency rules. Under the proposals, companies incorporated in Norway are deemed to be resident in Norway for tax purposes. Further, non-resident companies would be deemed to be resident in Norway if effective management and control is carried out in Norway. The proposed legislation also provides a tie-breaking rule for companies resident in a country having a tax treaty with Norway. If resident in the other treaty state, the company would be considered resident in Norway.

The proposed rules on tax residency were issued in a public consultation paper. In the State Budget for 2018, the Ministry of Finance stated that the new rules are expected to be submitted to the Norwegian parliament in 2018.

The general corporate tax rate was reduced to 23 percent (from 24 percent), as of fiscal year 2018.

Asset purchase or share purchase

An acquisition in Norway usually takes the form of a purchase of the shares of a company, rather than its business and assets, as the sale of shares may be exempt. Thus, it can be useful to purchase entities by setting up a Norwegian purchasing entity so the investor may exit without any major tax costs and reinvest in another Norwegian entity.

Acquisition of a Norwegian company may be carried out either through a share purchase or asset purchase, or by a merger. (See 'Choice of acquisition vehicles'.)

A number of aspects related to asset acquisitions are discussed below, followed by a discussion of share acquisitions.

Purchase of assets

A purchase of assets would generally result in an increase in the tax base cost base, both for capital gains taxation and depreciation purposes. This increase is likely to be taxable for the seller, so a seller would thus normally prefer to sell shares in order for the exemption method to apply. An asset purchase would enable the purchaser to avoid assuming potential historical tax risks and tax attributes and may thus be preferred from the buyer's perspective.

Purchase price

The purchase price must be allocated among the individual assets, and this allocation determines the tax bases for future depreciations.

Goodwill

Goodwill paid for a business (acquired goodwill) may be depreciated for tax purposes at 20 percent on a declining-balance basis. Time-limited intangible rights, such as leasing contracts, rights of use or patents, are depreciated on a straight-line basis over the lifetime of the asset.

Non-time-limited intangible rights, such as a company name or brands, are only depreciable where there is a clear decrease in value, in which case the right is amortized over the asset's projected lifetime.

The seller is taxed on any gain on intangible assets and goodwill. The gain could be deferred and taxed at 20 percent on a declining balance through the company's gain and loss account. A higher amount could be entered as income.

Depreciation

All assets used in the business are depreciable if they are either listed in the following depreciation groups or are documented as having lost value over time. The rates for different depreciation groups are as follows:

a. office equipment: 30 percent

b. acquired goodwill (business value): 20 percent

c. trucks, trailers, buses, taxis and vehicles for disabled persons: 24 percent

d. automobiles, tractors, machinery and equipment, tools, instruments, fixtures and furniture, etc.: 20 percent

e. ships, vessels, drilling rigs, etc.: 14 percent

f. aircraft and helicopters: 12 percent

g. plant and certain machinery for the distribution of electric power and electro technical equipment for the production of electric power: 5 percent

h. buildings, hotels, restaurants, etc. including but not limited to cleaning plants, cooling systems, pneumatic systems and similar technical and auxiliary plants and installations: 4 percent

i. office buildings: 2 percent

j. permanent technical installations in buildings, including sanitary installation, elevators etc.: 10 percent.

Plant and buildings with an estimated lifetime of 20 years or less may be depreciated at 10 percent, rather than 4 percent. However, the increased depreciation rate of 10 percent does not apply to plant and machinery used in petroleum activities outside the European Union (EU)/EEA.

Automobiles, tractors, machinery and other assets covered by category (d) may be depreciated with an additional 10 percent in the year of acquisition (for a total of 30 percent in the acquisition year). The same applies if an investment or upgrade is made to an asset in category (d).

All the tangible assets listed and acquired goodwill are subject to the declining-balance method of depreciation. Assets in groups (a) to (d) are depreciated on an aggregate (pool) basis. Each asset in groups (e) to (i) must be depreciated separately. Assets in group (j) must be depreciated on an aggregated basis per building.

The depreciation rate assets in depreciation group (c) were increased to 24 percent (from 22 percent), as of 1 January 2017.

Value added tax

Value added tax (VAT) is levied on any sale of assets, unless it can be deemed a transfer of a going concern. Sales of shares do not trigger VAT, but it is important to check whether the acquired company was part of a VAT group. Further, the continued business activity needs to be de-registered or re-registered for VAT purposes.

The disposal of operating assets or shares as part of the transfer of a business, or part of a business, to a new owner can take place without triggering VAT. One condition is that the new owner continues the activity within the same industry. If there is evidence of purchasing with the intention of closing down the business, a VAT liability is triggered.

Purchase of shares

A share sale is normally the seller's preferred choice as a Norwegian corporate seller benefits from the exemption method and does not remain liable for the business.

There are no immediate Norwegian tax consequences for a foreign company when it acquires shares in a Norwegian company. Thus, where goodwill is included in the value of shares and depreciation for tax purposes is not permitted.

Apart from the carry forward of losses, as described later in the report, the tax position of the acquired Norwegian company remains unchanged. Thus, there is no possibility of a tax-free step-up in the tax base of the assets of the acquired company.

An acquisition of shares can be restructured in such a way that the purchaser obtains tax benefits (see later in the report).

It is not possible to obtain assurances from the tax authorities that a potential target company has no tax liabilities or advice as to whether the target is involved in a tax dispute. It is thus recommended that the purchaser carries out due diligence prior to an acquisition. A normal part of the due diligence process involves a review of the tax affairs of the potential target company.

Financing costs generally are considered as ordinary operating costs and should be deductible when incurred. However, costs for legal assistance, other consultancy costs and costs for due diligence, among others, related to the purchase of shares are treated as part of the shares' cost price and should be capitalized on the shares. Due to the exemption method, the cost is not deductible for a Norwegian corporate shareholder.

Tax indemnities and warranties

Indemnities and warranties are commonly used in Norwegian transactions, and the parties may freely agree upon terms and conditions.

Tax losses

Losses of any kind may be set off against income from all sources and capital gains, and they may be carried forward indefinitely. Changes in ownership do not change the right to carry forward, provided that it is not likely that the exploitation of the losses was the main motive for the transaction.

Pre-sale dividend

Dividend payments are taxable to the receiver, regardless of whether the dividends are paid before or after the transaction or whether the payment is made to the old or new shareholder.

Transfer taxes

Norway does not have transfer taxes, except for registration of new legal owners of cars and real estate. Stamp duty on real estate is 2.5 percent of the fair market value. Stamp duty for real estate is not payable when shares are transferred in a corporation holding real estate or the real estate is a part of a demerger.

Tax clearances

It is possible to get pre-clearance from the tax authorities on transactions, usually in 1–3 months, provided the facts are clearly presented.

Choice of acquisition vehicle

The following vehicles may be used to acquire the shares and assets of the target:

— local holding company

— branch of a foreign company

— subsidiary of a foreign company

— treaty country intermediary

— joint venture.

Generally, the advantages and disadvantages of the different acquisition vehicles must be considered case-by-case.

Local holding company

There is no consolidation of groups for tax purposes, but relief for losses may be claimed within a group by way of group contributions. Group contributions are deductible for the contributor and taxable income in the hands of the recipient. The holding requirement for group contribution purposes is 90 percent. The parent company must hold, directly or indirectly, more than 90 percent of the shares and the voting rights of the subsidiary. The ownership requirement must be met at the end of the fiscal year.

Note that group contribution (with tax effect) may not be given or received with respect to income subject to the Norwegian petroleum taxation regime.

The tax deduction for a group contribution is conditional on the contribution not exceeding the taxable income of the contributor, and the requirements for contributions under the Companies Act must be met. Under the Norwegian Companies Act, any contribution from a company to a shareholder, except for the repayment of the share capital, must conform to the rules concerning dividends. Both the contributor and the recipient must affirm that the required conditions are fulfilled at the end of the income year in an enclosure to the tax return for the year of contribution.

Group relief is available between Norwegian subsidiaries of a foreign parent as long as the 90 percent ownership requirement is fulfilled by 31 December. This applies to foreign companies resident within the EEA that are considered comparable to Norwegian companies, as long as they are taxable to Norway through a permanent establishment and the group relief is taxable to Norway. Also, under non-discrimination clauses of tax treaties, group relief is available for contributions made from a branch of a foreign resident company to a Norwegian subsidiary of the same tax group.

Foreign resident company

A non-resident company acquiring assets in Norway would generally be deemed to have a permanent establishment. The taxation of a permanent establishment is normally the same as the taxation of a company. However, the company is free to remit the profit without awaiting completion of the formalities, such as approving the annual accounts or deciding a dividend distribution, and there is no requirement that distributions are within distributable equity.

Non-resident intermediate holding company

Norway has comprehensive tax treaties with more than 90 countries, including all industrialized countries and most important developing countries.

Local branch

A non-resident company normally carries on business in Norway through a Norwegian corporation (subsidiary) or through a registered branch. The corporate tax rate of 23 percent applies to both subsidiaries and branches.

Although the choice of the legal form of an enterprise should be determined case-by-case, the following tax issues should be considered:

— Profits of a branch are currently taxed in Norway (the source country) as well as in the home country (where the source country tax is normally credited against the home country tax unless an exemption applies), while profits of a subsidiary are taxed in Norway only. If distributed, the dividend taxation of the owner must be examined separately for each situation.

— A branch cannot deduct interest on loans from the head office.

— No branch profits tax is withheld in Norway. Likewise, distributions from a Norwegian subsidiary are normally not subject to withholding tax (WHT), but each case must be examined separately.

— Subsidiaries and branches are not subject to net wealth tax.

— Filing requirements are more extensive for subsidiaries than for branches.

Joint venture

No special tax legislation applies to joint ventures.

Choice of acquisition funding

Debt

Interest on loans is normally deductible for the purposes of calculating the net profits from business activities where the loan is taken out for the purpose of acquiring shares. The deduction is made on an accrual basis.

Intragroup interest deduction limitation

Interest limitation rules may however reduce the deductibility of interest costs to related parties. The basis for the calculation is the taxable income as stated in the tax returns, including adjustment for group contribution.

Tax-exempt income, such as certain dividends and gains on shares, does not increase the basis for deductions. Tax depreciation and net interest expenses (on both related-party debt and debt to unrelated creditors) are added back to the taxable income, and maximum deductible interest on related-party debt is capped at 25 percent of this amount. Payments to third parties also count toward the maximum deductible interest.

The rules apply to interest expenses from related parties (directly or indirectly hold 50 percent or more of the shares) and to loans guaranteed by related parties. Note however that loans guaranteed by subsidiaries as well as loans granted with security in the underlying subsidiaries' shares are outside the scope of the interest limitation rules.

Companies with tax losses carried forward are required to pay tax on non-deductible interest insofar as it exceeds current-year losses, as it may not be set off against increased income under the interest limitation rules.

The rules do not apply to companies with 5 million Norwegian krone (NOK) or less in net interest costs (including interest on related-party and third-party debt). Disallowed related-party interest costs can be carried forward for up to 10 years.

The financial sector and the petroleum industry are currently exempt from the rules.

The arm's length principle continues to apply in addition to the interest deduction limitation rules. KPMG in Norway assumes the principle would be applied in exceptional cases since the new rules are strict; however, this remains unclear. Where a Norwegian company is thinly capitalized, the tax authorities may deny the deduction of part of the interest, or part of the interest might be considered a dividend distribution to the foreign parent company.

Withholding tax

There is no WHT on interest or royalties. The Tax Commission's 2014 report on tax reform recommended that Norway implement WHT on interest and royalty payments. In the report, a 'royalty' would include lease payments on certain tangible assets, such as bare-boat rentals of vessels and rigs. WHT on royalty and interest has not yet been introduced, but a cross-party agreement from 2016 states WHTs need to be reviewed in more detail, including WHTs on lease payments. It is expected that the Ministry of Finance will prepare a discussion paper for public consultation.

These recommendations were not proposed in the 2018 state budget, but a cross-party agreement maintains that WHTs need to be reviewed in more detail, including WHTs on lease payments. The Ministry of Finance is expected to prepare a discussion paper for public consultation.

Checklist for debt funding

When funding a Norwegian entity, the following questions should be asked:

— Will the intragroup interest legislation limit the deduction of intragroup interest? Will interest paid to a third party be considered as intragroup interest due to debt secured by intragroup guarantees?

— Is there a business reason for setting up a Norwegian purchasing entity? If not, the anti-avoidance rules may apply and the interest deemed void for tax purposes.

— Is the interest set at fair market value? If so, are the market conditions well documented (e.g. similar types of loan, similar market, similar security, etc.)? For subordinated loans, interest could be challenged if the situation of the company is such that the interest poses a threat to the equity.

Equity

There is no capital duty of any kind on contribution to equity.

Hybrids

The tax treatment of a financial instrument usually is determined by the instrument's form rather than its substance. No single characteristic is decisive, but the following characteristics are considered to be typical of debt:

— There is an obligation to repay the capital, possibly with the addition of interest.

— There is an agreement governing interest, date of maturity and the loan's priority in relation to other creditors.

The following characteristics are considered to be typical of equity:

— A right is granted for a share in surplus liquidity and any dividend in the intervening period.

— The equity must take a certain form and be subject to certain restrictions and obligations regarding repayment of the provider of capital.

— The equity is intended to cover ongoing losses, and the yield is conditional on the company's performance.

Deferred settlement

Any settlement that permanently reduces the company's obligation to make payments or reduces its claims against third parties is accepted as income/loss at the time of settlement, as long as the settlement is made with third parties. Any settlement within a group must be documented as a fair market action, or the tax authorities will likely challenge it.

Other considerations

Concerns of the seller

The seller normally prefers a sale of shares, because this frees them from responsibilities and historical risk and attracts more favorable tax treatment. However, the tax benefit is normally a part of the purchase price discussions, which makes the choice less crucial for both parties.

Company law and accounting

In Norway, labor laws are protective and favor employees, who are entitled to have all their earned rights transferred with them.

Norwegian legislation also makes all contracts, etc., valid after a sale of shares, unless there are specific changes of control clauses or a change of ownership is clearly a breach of important explicit and implicit conditions.

For the dissolving entity, a formal merger is not considered liquidation. The company is regarded as a fully continuing corporation in all legal aspects unless the contracts state otherwise.

For accounting purposes, a purchase of assets is considered as a transaction, and the purchase price must be allocated. Only transactions within a group, without change of control, are treated as continuous transactions, provided the consideration is shares in the purchasing company.

Group relief/consolidation

There is no consolidation of groups for tax purposes, but relief for losses may be claimed within a group by way of group contributions. Group contributions are deductible for the contributor and taxable income for the recipient. The holding requirement for group contribution purposes is 90 percent. The parent company must hold, directly or indirectly, more than 90 percent of the shares and the voting rights of the subsidiary. The ownership requirement must be met at the end of the fiscal year.

Group contribution (with tax effect) may not be given or received with respect to income subject to the petroleum tax regime.

Group contribution is available between Norwegian subsidiaries of a foreign parent as long as the 90 percent ownership requirement is fulfilled at year-end. The same applies to foreign companies resident within EEA, which are considered comparable to Norwegian companies regarding group relief as long as they are taxable in Norway through a permanent establishment and the group relief is taxable in Norway. Also, under non-discrimination clauses of tax treaties, group relief is available for contributions made from branch of a foreign resident company to a Norwegian subsidiary of the same tax group.

Mergers/demergers and exchanges of shares

Takeovers

If a foreign company wishes to gain control over a business run by a Norwegian limited company, the foreign company can either purchase all the shares in the Norwegian company or purchase the business activity. Takeovers may also be carried out as mergers.

Mergers and demergers

The formal rules for mergers and demergers of companies are set out in the Limited Companies Acts. A proposal for a merger agreement is drawn up by the boards of the two companies and presented to the general assembly of both companies. The resolution of the general assembly of both companies must be reported to the National Registry of Business Enterprises within 1 month. If not, the merger is not effective. When the merger resolution has been registered, the registrar will publish the resolution and notify the companies' creditors that they must report their claims to the companies within 2 months from the date of the last announcement if they intend to object to the execution of the resolution. Corresponding rules apply to demergers.

Tax treatment of mergers and demergers

Mergers and demergers may be treated neutrally for tax purposes. The companies may also carry tax losses forward after the merger, subject to anti-avoidance provisions. A prerequisite for tax neutrality is that there is continuity in the involved tax positions before and after the transaction.

Further, the Ministry of Finance may, on application, grant a tax reduction or relief from tax on group reorganizations that would otherwise not qualify for neutral treatment. However, the application procedure may be lengthy and the application must be made in advance of the planned transaction.

Conversion of a Norwegian registered company into a branch of a foreign company

The conversion of a Norwegian registered company into a branch of a foreign company resident within the EEA-area may be carried out by way of a merger of the Norwegian company into the foreign company. This type of merger or demerger may be carried out on a tax-neutral basis.

Further, such a conversion may be carried out by way of liquidation of a Norwegian company held by a non-resident company. For tax purposes, the liquidation will entail a full realization of the assets and liabilities of the Norwegian company. As a general rule, gains on the realization of assets are taxable at a rate of 24 percent. Losses are deductible. Under certain conditions the shareholders may apply for tax deferral, which is often granted.

Cross-border mergers/demergers and exchanges of shares

Rules introduced in 2011 allow for tax-neutral cross-border mergers and demergers between Norwegian private limited companies/public limited companies and foreign limited companies that are resident within the EEA area. A merger or demerger between a Norwegian transferring company and a foreign qualifying company does not trigger taxation at the company or shareholder level.

In 2015, the Norwegian government amended the rules on cross-border intragroup transfers of assets and liabilities. The new rules apply to:

— transfers from a limited liability company to a foreign limited liability company within the same group

— transfers from a Norwegian partnership to a foreign partnership within the same group.

However, if assets, rights or liabilities are taken out of Norwegian tax jurisdiction, the general exit tax rules will apply. The legislation also allows for the tax-neutral exchange of shares, when transferring at least 90 percent of the shares in a Norwegian transfer or private limited company/public limited company in consideration for shares in a foreign resident company. The same applies when the transferee company is resident in Norway and the transfer or company (limited liability) is resident in another country. These rules apply both within and outside the EEA area.

A general condition for tax-free cross-border mergers, demergers and exchanges of shares is that the participating companies are not resident in low-tax countries within the EEA area, unless the company is genuinely established and carries on business activities in the EEA country. Exchanges of shares can also be carried out outside of the EEA, provided that the companies are not resident in low-tax countries.

A general condition under the rules is that the transaction is tax-neutral in all countries and that all tax positions are unchanged for the shareholders and the companies involved. There are some exceptions.

Business reorganizations

The Ministry of Finance has the authority to adopt regulations on tax-free transfers of businesses, etc., in the following cases:

— transfers of a business in a Norwegian company's foreign branch to a limited company in the same country

— transfers of a business in a Norwegian branch of a foreign company to a Norwegian limited company

— transfers between branches of related assets, liabilities and business, provided that the foreign-owned companies constitute a part of a group.

Transfer pricing

In Norway, transfer pricing policies must be documented at the request of the tax authorities. Failing to comply with such a request leads to fines. In addition, the company must keep a documentation file that can be forwarded to the tax authorities on short notice. Transfer pricing documentation rules impose an obligation for companies to prepare specific transfer pricing documentation. Norway's transfer pricing system is based on the OECD's guidelines.

Dual residency

Dual residency is treated in accordance with a relevant tax treaty between Norway and another country.

However, domestic law clearly states that a person is a Norwegian tax resident if they spend more than 183 days in Norway in any given 1-year period.

Norwegian exemption method

Corporate shareholders are exempt from taxation of dividends and gains on shares, except for a clawback of 3 percent on dividends. The clawback does not apply if the dividend is distributed within a tax group. Losses on shares qualifying under the exemption method cannot be deducted.

For individual shareholders, dividends and gains are taxed under a modified classical system.

Exemption for dividends and gains on shares in companies resident in the EEA

For corporate shareholders, an exemption system generally applies to all investments within the EEA. For companies resident in low-tax jurisdictions within the EEA, the exemption method only applies if the investee company fulfils an additional substance requirement. In the language of the legislation, the exemption only applies if such a company is genuinely established and performs real economic activity in the relevant jurisdiction. Fulfilling this criterion is based on the particular facts and circumstances. A key factor is to consider whether the foreign entity is established in a similar way to what is normal for such entities in both the country of residence and Norway.

If the investment qualifies, the exemption method covers dividends and gains on shares and derivatives where the underlying object is shares, regardless of the level of holding or holding period. Trading in shares and certain derivatives is thus tax-exempt when made from a Norwegian resident limited company.

Convertible bonds are not covered by the exemption method.

Losses on shares in a company which is a tax resident in a low-tax country within the EEA and lack the sufficient substance are not deductible, as the shares, in the case of a loss, qualify under the exemption method, even though a gain or dividends would not.

Limitation of exemption for investments outside the EEA

For investments outside the EEA area, the exemption only applies if the shareholder holds 10 percent or more of the share capital and the voting rights of the foreign company. The shares must be held for a period of 2 years or more. Losses are not deductible if the shareholder, at any point during the last 2 years, has held 10 percent or more of the share capital or the voting rights of the foreign company. The exemption does not apply to investments outside the EEA, where the level of taxation is below 2/3 of the Norwegian tax that would have been due if the foreign company had been resident in Norway (both a white list and a black list exist). Dividends are

tax-exempt from day 1, provided that the criteria are met at a later time.

For investments outside the EEA not qualifying for the exemption, dividends and gains are taxable and losses are deductible. For such investments, a credit for WHT and underlying tax is granted.

Exemption from withholding tax on dividends for EEA resident corporate shareholders

The exemption method also provides for a tax exemption for shareholders resident within the EEA, meaning that no Norwegian WHT is due for shareholders that are covered by the exemption method. The exemption method only applies if the shareholder fulfils a substance requirement (see above). In the language of the legislation, the exemption applies only if the company is genuinely established in and performs real economic activity in the relevant EEA country. Fulfilling this criterion is based on the particular facts and circumstances. A key factor is to consider whether the foreign entity is established in a similar way to the normal organization of such entities in both the country of residence and Norway.

Shareholders resident outside the EEA would still be charged WHT, subject to limitations under tax treaties.

Comparison of asset and share purchases

Advantages of asset purchases

— The purchase price (or a portion) can be depreciated or amortized for tax purposes.

— A step-up in the cost base for tax purposes is obtained.

— No previous liabilities of the company are inherited.

— No acquisition of a tax liability on retained earnings.

— Possible to acquire only part of a business.

Disadvantages of asset purchases

— Possible need to renegotiate supply, employment and technology agreements, and change stationery.

— A higher capital outlay is usually involved (unless debts of the business are also assumed).

— Possibly unattractive to the vendor, so the price may be higher.

— Accounting profits may be affected by the creation of acquisition goodwill.

— Potential benefit of any losses of the target company remains with the vendor.

Advantages of share purchases

— Lower capital outlay (purchase net assets only).

— More attractive to the vendor, since a capital gain is (almost) tax-free for companies.

— Purchaser may benefit from tax asset and losses of the target company.

— Purchaser may gain the benefit of existing supply and technology contracts.

Disadvantages of share purchases

— Purchaser acquires an unrealized tax liability for depreciation recovery on the difference between the market and tax book values of assets.

— No deduction for the purchase price or underlying goodwill.

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Poland

Introduction

The Polish tax and legal systems have undergone substantial changes since the early 1990s, first to address the needs of a market economy and later to adjust to European Union (EU) law, as required by Poland's accession to the EU on 1 May 2004.

Poland has fully incorporated the EU Parent-Subsidiary Directive [90/435/EC], Merger Directive [90/434/EC], and Interest and Royalties Directive [2003/49/EC], and the EU-Swiss Savings Agreement, as well as the main assumptions resulting from the EU Anti-Tax Avoidance Directive (ATAD) [2016/1164/EC] and EU Directive as regards mandatory automatic exchange of information in the field of taxation [2014/107/EC]. Poland is also the third country to have ratified the Multilateral Instrument (MLI) to Modify Bilateral Tax Treaties.

Recent developments

Recent developments in the Polish tax law have substantially affected the tax environment and could have a major impact on mergers and acquisitions (M&A).

A general anti-abuse rule (GAAR) came into force in Polish tax law on 15 July 2016. The GAAR is intended to prevent artificial arrangements aimed solely or mainly at deriving unlawful tax advantages. In principle, under the GAAR, an activity/arrangement undertaken with the intent of achieving a tax benefit that is contrary to the subject and aim of the relevant regulations in the tax legislation does not achieve the desired tax benefit if the activity or arrangement was artificial (for tax avoidance purposes). The GAAR should not apply:

— where the tax benefits do not exceed 100,000 Polish zloty (PLN) (in aggregate during the relevant settlement period or on a one-off basis, depending on the situation)

— to entities that have a protective opinion issued by the Minister of Finance (until it is changed or cancelled) or have applied for such an opinion that has not been issued on time (until the opinion is issued)

— where other tax regulations (i.e. special anti-abuse rules) already counteract the tax avoidance.

Therefore, any restructurings involving Polish entities that results in significant tax benefits should have a strong business justification.

Further, the Ministry of Finance started publishing official letters warning taxpayers that some widely used mechanisms may be seen as abusive and leading to tax avoidance. These include, among others, tax optimization schemes involving the use of intermediary EU holding companies for dividend exemption, certain management incentive plans and transactions with bonds within structures involving closed-ended investment funds.

As of 1 January 2017, the taxpayer's taxable gain resulting from an in-kind contribution in a form other than a business or its organized part is determined to be the amount of such contribution specified in the statute, articles of association or other document (generally, market value), instead of the nominal value of shares acquired in exchange for an in-kind contribution under the former corporate income tax (CIT) provisions. As a result, hidden reserves disclosed on the above transactions are now subject to CIT.

As of 1 January 2017, to benefit from the preferential taxation for share-for-share exchange transactions, valid business reasons should exist. In addition, as of 2017, where a merger, demerger or a share-for share exchange was not carried out for valid business reasons, it would be deemed to have been executed with the main objective (or one of the main objectives) of avoiding or evading taxation.

In January 2017, a definition of 'beneficial owner' was added to the Polish CIT Act. Under the definition, the beneficial owner must receive interest for its own benefit and should not act as intermediary, representative, trustee or other body obliged to transfer the interest received to the other entity (in whole or in the part). This definition seems vague as it does not precisely describe the elements of substance that an entity requires to meet the definition.

As of 1 January 2017, a new real estate clause in the Polish CIT Act took effect. Generally, a disposal of shares in a company whose value is derived mainly from real estate is taxable in Poland, provided that the relevant tax treaty contains a real estate clause. Additionally, indirect transfers of such shares may be taxable in Poland where the relevant tax treaty contains a real estate clause.

As of 1 January 2017, a reduced 15 percent CIT rate was introduced for so-called 'small' taxpayers and taxpayers starting business activity in their first tax year.

In January 2017, the Polish legislator reinstated value added tax (VAT) sanctions, including an additional tax liability of 20 percent, 30 percent and 100 percent of the understated VAT liabilities or overestimated refund for certain infringements of the VAT Act provisions.

In April 2017, a new bill on exchange of information with other countries came into force. The aim of this regulation was to implement the Euro-FATCA Directive, as well as to introduce provisions enabling fulfilment of the obligations under the Competent Authority Agreement with respect to the Common Reporting Standards (CRS). As a result, new reporting obligations have been imposed on Polish companies belonging to international capital groups.

On 1 January 2018, some important CIT amendments were introduced:

— **Disallowance of deductibility of interest on debt push down structures**: This amendment denies tax deductions for interest on credits and loans incurred to acquire shares in a company, insofar as they would reduce income related to the continuation of the business of that company, in particular in connection with a merger and transformation of the legal form.

— **Separation of sources of income and loss**: The bill implemented a concept of two sources of income: capital gain (e.g. from a sale of shares) and income from business activity. As a result, taxable profits and tax-deductible costs are to be separately settled for CIT purposes. Taxpayers must recognize tax losses incurred within each income source separately, except for the tax losses incurred before the provisions entered into force, which can be settled with both sources of income.

— **Changes to thin capitalization rules**: The thin capitalization rules are extended to loans granted by unrelated parties. The deduction of net financing costs is limited to 30 percent of earnings before income tax, depreciation and amortization (EBITDA) in relation to the surplus of interest over PLN3 million. In addition, the tax authorities can now assess income or tax loss if the cost of debt financing exceeds the amount that the taxpayer would have received from an unrelated party (based on taxpayer's market creditworthiness).

— **Limitation of deductibility of fees for intangible services**: As of 1 January 2018, fees paid for certain intangible services (e.g. consultancy, advertising, marketing, data processing), royalties and insurance costs, guarantees and suretyships are excluded from tax-deductible costs if they exceed 5 percent of EBITDA. The limitation covers payments made directly or indirectly to related parties. The restrictions do not apply if the taxpayer obtains an advance pricing agreement (APA) from the Polish Ministry of Finance in that regard. The restriction does not apply to the fees for intangible services up to PLN3 million annually.

— **Minimum taxation on commercial property**: A minimum taxation is introduced for commercial or office buildings (e.g. shopping centers, department stores, boutiques) with an initial value exceeding PLN10 million. The tax rate is 0.42 percent per year of the surplus of the initial value over PLN10 million. The tax is not levied on real estate assets used exclusively or mainly for the taxpayer's own purposes. Taxpayers may deduct the commercial property tax from their CIT base.

— **Tax rules on demergers**: The new CIT rules changed the determination of profits and costs on the sale of shares in a demerged company after the spin-off (where the transaction was based on the organized parts of enterprise). The shareholder's income is now based on the issue value of shares, which is understood as the shares' acquisition price, which cannot be lower than their market value.

— **Economic substance (anti-avoidance) clause for certain in-kind contributions**: As of 1 January 2018, contributions of a business or of an organized part of a business are not tax-neutral without a valid business purpose.

— **Tax capital group rules**: As of 1 January 2018, the minimum average share capital of entities required to form a tax capital group was reduced to PLN 500,000 (from PLN1 million), direct stake threshold was reduced from 95 percent to 75 percent and the minimum profitability ratio was reduced to 2 percent (from 3 percent). Moreover, donations made within a TCG are no longer tax-deductible.

— **Controlled foreign company rules**: Controlled foreign company (CFC) status currently depends on, among other things, the effective tax rate imposed on the foreign company (in lieu of a nominal tax rate). The passive profits threshold has decreased to 33 percent (from 50 percent), and the required 'controlling' stake has increased to 50 percent (from 25 percent).

In November 2017, a new draft bill of Tax Ordinance Act has been announced. As the bill proposed assumes introduction of several important new regulations, it is therefore considered to be an overhaul of the Polish general tax law principles, in particular those governing tax proceedings. The bill is expected to come into force as of 1 January 2019.

Also in November 2017 the Polish Ministry of Finance and Development announced a project of a new system of special economic zones (SEZ), administratively separated parts of Polish territory providing certain incentives for the investors (i.e. CIT exemption). The legislation is expected to enter into force in 2018, but its final wording may change during the legislative process. Highlights of the proposals are as follows:

— **No territorial restrictions**: The CIT would be available throughout Poland, not only in SEZ-covered territory as currently.

— **New access criteria**: Investment expenditure would be based on the unemployment rate (quantitative criteria) and compatibility with Poland's Mid-Term Development Strategy (qualitative criteria); these criteria will be defined in further regulations.

— **Time-limited relief** — A decision to allow the CIT exemption for an investment would be limited to a fixed period of 10 to 15 years.

The current system is expected to continue to operate until 2026, but only for permits issued before the new system enters into force (until 2026, two systems will operate in parallel).

In July 2018, a voluntary split payment system for VAT will be introduced, giving buyers the choice of paying VAT amounts into a dedicated bank account of the seller. In some cases, entities that decide to apply the split payment mechanism are expected to receive a number of incentives (e.g. lack of VAT sanctions).

Asset purchase or share purchase

An acquisition in Poland could take the form of a purchase of the shares of a company, its business or particular assets. However, there is no one preferential form for the acquisition, as the chosen form could depend on many circumstances and the objectives of the entity concerned.

Purchase of assets

Minimal formalities usually mean a purchase of single assets is a swift procedure unless real estate is involved. Only technical issues related to the transfer of the assets affect the timing and signing of the sale agreement.

Purchase price

The sale price should be based on the market value of the assets.

Goodwill

No goodwill arises for tax purposes on such transactions.

Depreciation

For the buyer, the acquisition price of the fixed assets and intangibles is the base for tax-depreciation purposes. Individual depreciation rates (higher than the standard rate) can normally be applied to secondhand assets.

Tax attributes

Tax losses are not transferred on an asset acquisition; they remain with the seller.

For the seller, a profit on the sale of assets is added to the mainstream income subject to corporate or personal income tax at normal rates. On disposal, the taxpayer can deduct the net value of the assets. No relief is available to reduce the tax burden. Any losses of the selling company can be used to offset any profit (subject to the normal restrictions).

Value added tax

VAT arises on the sale of goods (e.g. stock, equipment) and certain intangibles. Currently, the standard VAT rate is 23 percent.

Generally, sales of buildings, constructions and their parts are VAT-exempt (except where the sale is performed in principle before the period of 2 years from the first occupation expires). However, in most cases, the taxpayer can waive the exemption where certain conditions are met. Supplies of buildings, constructions and their parts are also VAT-exempt if the seller has no right to deduct input VAT on the sale and certain other conditions are met.

Transfer taxes

Where the sale is VAT-exempt, it is usually exempt from transfer tax on civil law activities (PCC), except for land and buildings. The purchase of real estate is subject to 2 percent PCC even if VAT-exempt.

A sale of assets outside the scope of VAT is subject to PCC of 1 or 2 percent, payable by the buyer. There is no separate PCC land tax in Poland.

Purchase of a business or organized part of a business

The sale of a business or an organized part of a business gives rise to taxable income for the seller on the difference between its acquisition cost for tax purposes and the sale price taxed at normal corporate rates. For an individual, such profit is taxed in the same way as normal business income.

The purchase of a business or organized part of a business is very quick if land is not included. The main complication is the need to prepare detailed lists of assets and liabilities and arrange for the transfer of agreements. In certain cases, permission of the competition authorities and/or the European Commission is required. The buyer generally is the legal successor for most purposes, but administrative decisions and permits generally do not automatically transfer.

The purchase of a business or an organized part of a business is generally advantageous where the disposing company has tax losses to offset against any potential taxable gain arising on the transaction and the acquiring company can benefit from tax-depreciable goodwill.

The buyer can depreciate the assets purchased based on their market value if goodwill arises. If no goodwill arises, the depreciation base of fixed assets and intangibles is the difference between the purchase price and current assets less liabilities. Goodwill can be depreciated for tax purposes over a minimum of 5 years. Where the assets are regarded as secondhand (more than 6 months old for movable property or 5 years old for buildings), individual depreciation rates (higher than standard rates) can be applied. Difficulties can arise if liabilities are included, especially in connection with the deductibility of interest on assumed debt.

VAT and transfer taxes

Where a whole business or an organized part of a business is sold, the transaction should be outside the scope of VAT. Instead, it is subject to PCC of 2 percent on movable property and real estate and 1 percent on rights. The buyer is liable for the PCC payment.

Responsibility for tax liabilities

The buyer of a business or an organized part of a business is jointly and severally liable with the seller for the tax liabilities relating to the acquired business activity that arose prior to the purchase, up to the amount of the purchase price (unless, despite acting with appropriate care, the buyer was not able to identify such tax liabilities). The seller or the buyer (with the seller's consent) can seek a certificate from the tax authorities confirming the seller's outstanding tax liabilities. In this case, the buyer would not be responsible for any liabilities not included on the certificate (which is valid for 30 days).

Purchase of shares

The purchase of a target company's shares does not cause an increase in the base cost of that company's underlying assets.

Any gain arising on the sale of shares is subject to CIT as income from capital. Any associated costs of acquisition that were previously disallowed are also deductible within this source of income. Gains on the sale of shares by an individual are subject to 19 percent income tax.

Tax indemnities and warranties

In a share acquisition, the buyer is taking over the target company together with all related liabilities. Therefore, the buyer normally requires more extensive indemnities and warranties than in the case of an asset acquisition.

Tax losses

Tax losses normally stay with a company (there is no change of ownership rule in Poland). Tax losses can be lost if the company is merged or split unless the loss-making company remains in existence. As of 2018, capital losses generated in 2018 and later years cannot be offset against operating income. Tax losses can be carried forward for up to 5 years. Only 50 percent of a tax loss from each previous period can be used in any 1 tax year.

Transfer taxes

Generally, a sale of shares is subject to PCC of 1 percent, calculated on the shares' market value (in practice, the sale price). The buyer is liable for the PCC. Generally, PCC tax applies regardless of the nationality of the buyer and the seller if the transaction includes shares in a Polish company (some tax-effective arrangements may be considered).

Purchase of partnership interest

Partnerships (except joint stock partnerships, as of 2014) are regarded as fiscally transparent for income tax purposes, with the profits and losses being allocated directly to the partners. On the sale of the business of a partnership, each partner is regarded as selling their allocable share of the partnership assets. The sale proceeds are taxable together with the value of any liabilities assumed by the buyer, but the net tax value of the assets being sold is deductible. Any profit is subject to tax at the normal rates.

The sale of an interest in a partnership is subject to PCC of 1 percent in Poland, calculated on the market value of the partnership share.

Partnerships are taxpayers for purposes of other taxes (e.g. VAT, PCC).

Choice of acquisition vehicle

Several potential acquisition vehicles are available to a foreign buyer, and tax factors often influence the choice. A 0.5 percent capital duty/PCC applies on capital contributions to a Polish company (share premium is not subject to capital duty in Poland).

Local holding company

Given the limitation on deductibility of interest incurred within debt push-down structures introduced as of January 2018, arrangements that use a Polish special-purpose vehicle acquiring debt to purchase the shares, followed by a merger with the target, are not tax-efficient.

Foreign parent company

The foreign buyer may choose to make the acquisition itself, perhaps to shelter its own taxable profits with the financing costs. Non-residents are not subject to tax in Poland on gains on the disposal of shares in a Polish company (unless a so-called 'real estate clause' in a relevant tax treaty applies). All transactions concerning real estate companies should be carefully analyzed.

Non-resident intermediate holding company

Where the foreign country taxes capital gains and dividends received from overseas, an intermediate holding company resident in another territory may be used to defer this tax and perhaps take advantage of a more favorable tax treaty with Poland.

However, in an official 2017 letter, the Ministry of Finance indicated that a structure interposing an EU holding company between the Polish company and a non-EU ultimate parent would potentially lead to tax avoidance on the taxation of dividends if the structure lacks substance.

Local branch

Acquisitions via a Polish branch are unusual in the Polish market. It is more common to conduct the business activity of a foreign entity through a branch.

Joint venture

Joint ventures can be either corporate (with the joint venture partners holding shares in a Polish company) or unincorporated (e.g. a partnership). Partnerships are generally

considered to provide greater flexibility from a tax viewpoint. For example, where the joint venture is initially expected to make losses, the partners should be able to use their shares of those losses against the profits of their existing Polish trades.

In practice, non-tax reasons may lead a buyer to prefer a corporate joint venture. In particular, a corporate body may enable the joint venture partners to limit their liability to the venture (assuming that lenders do not insist on receiving guarantees from the partners).

Choice of acquisition funding

A buyer needs to decide whether an acquisition will be funded with debt or equity. The main concern is often to ensure that the interest on any funding can be offset against the profits of the target to reduce the effective Polish tax rate.

Debt

The principal advantage of debt is the potential tax-deductibility of interest (see this deductibility of interest), as the payment of a dividend does not give rise to a tax deduction. As of 2018, however, where loans or credits are taken to fund a purchase the shares, it is no longer possible to deduct the interest cost from the business income of the acquired company. By contrast, the costs of a share issue are not generally tax-deductible.

However, according to an interpretation of the administrative courts, this treatment relates only to direct costs (e.g. court fees). Still, the tax authorities' interpretation of the tax-deductibility of these costs should be carefully observed case-by-case.

Until the end of 2017, a typical scheme considered using a debt push-down structure. Because of limitations introduced on the deductibility of interest incurred within such structures and the new distinction between types of income, these scenarios are no longer tax-effective.

PCC is levied on loans (from non-shareholders) at a rate of 2 percent but can be mitigated if properly structured.

Loans from banks or financial institutions are PCC-exempt. Shareholder loans granted to corporates are PCC-exempt. Loans granted by partners to partnerships generally are subject to 0.5 percent PCC.

Cash injections to increase the share capital and additional payments to a company's equity are subject to PCC at 0.5 percent (except for share premium).

Deductibility of interest

Interest incurred to earn revenue is normally deductible when paid within the respective source of income. However, according to Polish CIT provisions (and confirmed in various interpretations and court verdicts), the capitalization is a form of payment. The exception to this rule is when the loan is used to purchase fixed assets. In this case, interest up to the time the assets are brought into use should be capitalized as part of the acquisition cost of the assets.

Interest on a loan to buy shares is currently considered to be tax-deductible when incurred; however, the source of income in which they should be classified is uncertain.

When financing is to be taken by the Polish company, Poland's thin capitalization rules should be taken into account.

As of 1 January 2018, the amount of debt financing costs exceeding 30 percent of EBITDA is not tax-deductible.

For purposes of the new limitations, debt financing costs include all costs related to obtaining financial resources from other entities, including unrelated parties, and using such resources. In particular , this includes interest, including interest capitalized or included in the initial value of the fixed or intangible asset, fees, commissions, bonuses, the interest component of leasing instalments, penalties and charges for delays in paying liabilities, and the costs of securing liabilities, including the costs of derivative financial instruments, without regard to the recipient of the payment.

Interest-like revenues include interest revenues, including interest capitalized to the loan principal and other revenues economically equal to interest that could fall into a category of debt financing costs.

Surplus debt financing costs are the excess of debt financing costs deductible in the tax year over the interest-like revenues subject to the tax in that year. Debt financing costs related to loans used for financing a long-term public infrastructure projects are excluded (where certain conditions are met). In a TCG, debt financing costs and interest-like income resulting from agreements concluded between group entities are also excluded.

According to the new legislation, the restrictions do not apply where the surplus debt financing costs do not exceed PLN3 million in the given tax year (12 months). In the case of TCGs, the threshold applies to the whole group.

Where debt financing costs exceed the amount of financing that the taxpayer could obtain from a third party, the tax authority is entitled to adjust the taxpayer's income or loss.

Withholding tax on debt and methods to reduce or eliminate it

Interest, royalties and certain payments for services (including advisory, advertising and accounting services and guarantee fees) paid to a foreign entity are subject to 20 percent WHT under domestic legislation. This is reduced or eliminated under most Polish tax treaties. To qualify for the reduced rate, the payer must have a certificate of the beneficiary's tax residence. In addition, the entity receiving interest must be the beneficial owner. Where the interest is WHT-exempt under the domestic legislation, the status of the beneficial owner must be confirmed with a written statement.

Under current law, if the certificate confirming the tax residence of the payment's recipient does not include the period of its validity, then it should be considered as valid only for 12 calendar months following its date of issuance (as the data included in the certificate must be up-to-date). Where the recipient's seat changes during the 12-month period, a new certificate should be obtained immediately.

This practice applies only where the respective tax treaty includes an exchange of information clause.

The EU Interest and Royalties Directive is fully in force in Poland. Consequently, interest and royalties paid to EU-resident companies or EU permanent establishments (PE) can be exempt from WHT in Poland. In order to apply the exemption, the Polish company paying the interest or royalties should have appropriate documentation, which includes the beneficiary's certificate of residence and a written statement that the beneficiary's revenues are not CIT-exempt (regardless of their source). Similar provisions apply to Switzerland.

Checklist for debt funding

— The use of bank debt may eliminate transfer pricing problems and should obviate the requirement to withhold tax from interest payments. (The relevant tax treaties and the new beneficial ownership of interest rules should be analyzed.) A certificate of tax residence and, where the exemption claim is based on the EU directives, a shareholder statement is required.

— Deductibility of interest over PLN3 million on debt (including both related and unrelated) is limited to 30 percent of EBITDA.

— WHT of 20 percent applies to interest payments to non-Polish entities unless a lower rate applies under the relevant tax treaty or EU directive.

— Potential foreign exchange implications.

— PCC implications on providing funds.

Equity

A buyer may use equity to fund its acquisition, possibly by issuing shares to the seller in satisfaction of the consideration. Further, the buyer may wish to capitalize the target post-acquisition.

Any establishment (or increase) of the share capital in the Polish company is subject to 0.5 percent PCC in Poland (a share premium is not subject to PCC). Dividend payments from a Polish company may be exempt from WHT if the conditions of the EU Parent-Subsidiary Directive are met. Dividends are not deductible for Polish tax purposes.

Although equity offers less flexibility should the parent subsequently wish to recover the funds it has injected, the use of equity may be more appropriate than debt in certain circumstances, such as:

— low EBITDA and/or creditworthiness of the borrowing entity

— where the target is loss-making, in which case it may not be possible to offset the cost of interest

— where the funding company prefers not to recognize taxable revenue arising from interest.

Generally, dividends paid by a Polish company are subject to 19 percent WHT, which is reduced under most of Poland's tax treaties. To qualify for the reduced rate, the payer should have a certificate of tax residence for its shareholder.

In principle, foreign dividends received by a Polish company are subject to normal CIT, unless a tax treaty stipulates otherwise. The Polish company receiving the dividend can offset the WHT against its mainstream corporate tax liability where the treaty includes the respective provisions.

For 75 percent shareholdings in non-EU, non-European Economic Area (EEA) and non-Swiss tax residents, a credit can also be claimed for underlying tax paid on the profits from which the dividend is paid. This only applies where the subsidiary is resident in a country with which Poland has concluded a tax treaty and the Polish entity has held the shares for at least 2 years. The total foreign tax credits cannot exceed the Polish tax payable on the dividend income. However, this applies only where the relevant treaty includes an exchange of information clause.

Domestic dividends and dividends paid to an EU OR EEA-resident company (or its PE), where the shareholder owns at least 10 percent of the payer, are exempt from Polish WHT, provided the shares have been owned for more than 2 years. In order to apply the exemption, the Polish company paying the dividend should have appropriate documentation, which includes the beneficiary's certificate of residence and a written statement that the beneficiary's revenues are not CIT-exempt (regardless of their source). Dividends can qualify conditionally even where the holding period has not been met. This treatment also applies to dividends paid to Swiss shareholders (the required shareholding threshold is 25 percent) and European cooperative societies (*societas cooperativa Europaea* — SCE).

Dividends paid by an EU OR EEA subsidiary to its Polish parent company are exempt from income tax in Poland where the 2-year holding period is met and the subsidiary is taxable on its worldwide income in an EU OR EEA member state. The participation requirement for a Polish parent company is a shareholding of at least 10 percent.

This treatment also applies to dividends paid from a Swiss subsidiary to its Polish parent company. In this case, the required shareholding threshold is to 25 percent. These parent-subsidiary provisions also apply to SCEs.

Hybrids

The Polish tax system used to be very form-driven and generally classified hybrid instruments by their legal form. Currently, due to the legislative amendments aimed at artificial tax avoidance schemes, the Polish tax authorities

have adopted a more substance-oriented approach. Not only are the tax authorities authorized to re-characterize the transaction based on the substance over form principle, but they are also empowered to apply the GAAR. As the set of instruments granted to the authorities by the legislator expands, a need to have sufficient business justification before implementing planned transactions is ever more essential.

Discounted securities

Any discount on the issue of securities is recognized as a deduction for tax purposes when the security is redeemed. This is only treated as income for the buyer on redemption.

Deferred settlement

Any deferred settlement must be analyzed in detail case-by-case as its tax treatment in Poland depends on the wording of the agreements and circumstances of the transaction.

Other considerations

Based on the CIT law, in principle, any method of settling liabilities (e.g. by offset of mutual receivables/liabilities between the parties) should be treated as a payment and result in the recognition of foreign exchange differences for tax purposes (provided other conditions are met).

Many of the recently introduced regulations to the Polish CIT law are likely to have a significant impact on the CIT position of the Polish companies. As some aspects of the changed rules are ambiguous, the potential loopholes arising are yet to be established in the Polish tax authorities' practice. Therefore, when making the decision about undertaking a transaction involving any Polish-based company, it is recommended to observe how the market practice evolves in this respect.

Concerns of the seller

Sale of assets

Capital gains are subject to tax at the normal Polish CIT rate. In principle, the sale of assets is subject to VAT. The buyer is liable for any PCC payment. A capital gain obtained by an individual seller is subject to tax at normal progressive tax rates. However, where the individual is subject to flat-rate tax on business activities, the gain is taxed at 19 percent.

Sale of shares

Based on Polish income tax provisions, the seller is subject to CIT on a gain on the sale of shares of a Polish company. However, non-residents should not be subject to income tax in Poland under most Polish tax treaties (unless a so-called 'real estate' clause in the treaty applies).

Where the shares are acquired in exchange for a contribution in kind to an enterprise or an organized part of enterprise, a gain may be deferred until the shares are sold. A compulsory redemption of shares is treated as a dividend and the income derived thereupon is deemed as an income of a capital nature.

A share buyback is treated in the same manner as a gain on a sale of shares.

Gains on the sale of shares obtained by an individual are subject to 19 percent tax, settled within the capital source of income

Non-tax considerations

In principle, most investments in Poland do not require advance approval for non-strategic sectors. On an acquisition, the most common approval required is that of the Office for the Protection of Competition and Consumers, often referred to as the anti-monopoly office. The EU competition rules apply.

Where the Polish target company owns land, the buyer must obtain advance permission from the Ministry of the Interior to acquire more than 50 percent of the shares. As of 1 May 2004, this requirement does not apply to EU/European free trade area buyers.

In case of agricultural and forest lands there are still some restrictions.

Company law and accounting

Based on Polish Commercial Companies Code, the main forms of reorganizations are mergers and demergers of the companies. Another popular form of reorganization is the contribution in kind of a business or organized part of the business.

Merger

Two types of mergers are possible in Poland: a takeover by an existing company and a merger of two companies into a new company. From a legal perspective, the merger is the most complete method of integration because the acquiring company is the legal successor to all rights and obligations of the acquired company. A merger also generally ensures that administration decisions, concessions and permits are automatically transferred to the acquiring company. This is the general position, but other legal issues may be involved and each case should be analyzed separately. The interpretations of tax law issued by the Ministry of Finance to the company being subsequently merged into another entity (the acquiring entity) do not protect the latter after the merger.

Most mergers between Polish companies are tax-free for the merging companies and their shareholders, provided that no cash is distributed and/or that, before the merger, the acquiring entity owned either no shares or more than 10 percent of the shares of the acquired company.

The amendments to the CIT Act which has come into force as of 1 January 2017 introduced a presumption according to which if a merger was not carried out for valid business reasons it should be deemed as executed with the main objective (or one of the main objectives) of avoiding or evading taxation. Where it can be shown that the merger was not carried out for bona fide commercial reasons and that there was intent to avoid tax, the transaction is no longer tax-free.

Mergers do not affect hidden tax values, such as goodwill or increases in the value of assets. Existing prior-year tax

losses are eliminated unless the loss company survives. Generally, a merger may be beneficial where the business being transferred is profitable because unrealized gains are not taxed on the merger. A merger may also be beneficial where the company taken over has no significant tax losses (which would be lost on a merger). On the other hand, income derived upon mergers qualify as income from the capital source and therefore cannot be offset against tax deductible costs resulting from an ongoing activity.

Poland has fully adopted the EU Tax Merger Directive, so mergers between Polish companies and entities resident in EU member states are treated the same as domestic mergers.

Thus, under the commercial law, cross-border mergers can take place where a European company is being created. Also, domestic corporations (and limited joint stock partnerships) can be merged cross-border with the EU-based company described in the directive (although a limited joint stock partnership cannot be the acquiring entity).

Where the acquiring company has a shareholding of less than 10 percent of shares of the company being acquired, the value of the net assets acquired in excess of the acquisition costs of this shareholding is treated as a dividend. However, gains realized upon merger cannot benefit from the WHT exemption provided in the Polish CIT Act. The other shareholders of the entity being taken over are treated as realizing a gain equal to the difference between the acquisition cost of those shares and the issue value of new shares, but taxation is deferred until the new shares are disposed of.

Where a merger is accounted for using the acquisition method, the books should be closed on the date of the merger and the tax year-ends. There is no such obligation where the merger is accounted for using the pooling of interest method. In this case, the merged entity can file a single year-end return.

Mergers are outside the scope of VAT and, in principle, create no negative VAT consequences.

A merger of a Polish corporation and an SCE is not subject to PCC. Generally, any increase in share capital as a result of the merger is subject to PCC at 0.5 percent (provided the increase was not previously taxed in the merging entities, unless, in the case of a corporation, such non-taxation of contributions was allowed by the domestic law of the EU country of one of the merging companies).

Due to complex legal procedures, the process can take 6 to 8 months, although a merger of a parent and a 100 percent owned subsidiary or a merger of sister companies usually takes 4 to 6 months.

KPMG in Poland notes that the timeframes for cross-border mergers vary, depending on the local jurisdictions and the direction (inbound or outbound) of the merger. During recent years, cross-border mergers became more popular in Poland.

Demerger

A company may be divided into two or more companies.

A division of a joint stock company is not possible unless the initial capital is fully paid-up. Partnerships cannot be divided. A company in liquidation that has started distributing its assets to shareholders or a company in bankruptcy cannot be divided.

A division may be effected by:

— transferring all the assets of the company

— being divided to other companies in exchange for shares in the acquiring company, which are taken up by the shareholders of the divided company (division by takeover)

— forming new companies to which all the assets of the divided company are transferred in exchange for shares in the new companies (division by formation of new companies)

— transferring all the assets of the divided company to an existing company and a newly formed company or companies (division by takeover and formation of a new company) transferring some of the assets of the divided company to an existing company or a newly formed company (division by separation).

No CIT obligation usually arises for the demerged entity or its shareholders as long as an organized part of the business is transferred to the receiving entity and, in a division by separation, an organized part of the business remains in the company being demerged and an organized part of the business is transferred to the receiving entity. This does not apply where the main purpose of the demerger is to evade or avoid tax. In addition, the demerger is not tax-free if the acquiring entity has less than 10 percent of the shares of the company being demerged and/or the cash is distributed. The amendments to the CIT Act that came into force as of 1 January 2017 introduced a presumption that where demerger was not carried out for valid business reasons, it should be deemed as executed with the main objective (or one of the main objectives) of avoiding or evading taxation.

If the transaction is not tax-free, the following income tax implications arise:

— *Shareholders of the company (companies) being divided*: The difference between the value of the shares received and the acquisition costs of the original shares established in proportion to the transferred assets is treated as a dividend. However, gains realized on demerger may not be subject to the domestic WHT exemption.

— *Demerged company*: The difference between the market value of the assets being transferred and the tax written-down value is taxable or tax-deductible. The WHT exemption is not applied.

— *The entity receiving part of the demerged business*: The difference between the value of assets received and the issue value of the shares issued to the shareholders of the demerged company is treated as taxable income or tax-deductible.

Generally, a demerger should not be subject to VAT. Any increase in share capital is subject to PCC at the rate of 0.5 percent. Whether the increase of the share capital covered by assets that were previously taxed in the demerging entity is subject to 0.5 percent PCC should be analyzed case-by-case.

Contribution in kind

The contribution in kind of a business or an organized part of a business in exchange for shares is not subject to corporate tax at the time of contribution. As of 1 January 2018, the tax neutrality of such events depends having on valid business justification. A contribution of assets (including shares) is regarded as a taxable disposal. The contributor is regarded as having received proceeds equal to the value of contribution determined in the articles of association or another document of a similar nature. However, if the value of contribution is lower than the market value of contributed shares or the value is not indicated in the above documents, the income would be equal to the market value of the contribution performed.

For companies, any gain is added to the capital source of income and subject to corporate tax at normal rates. For individuals, a profit from a contribution of assets other than a business or organized part of a business in exchange for shares is subject to 19 percent tax. The contribution of shares carrying an absolute majority of voting rights in companies by a Polish company to another EU OR EEA-resident company is not subject to tax. In order to benefit from the preferential taxation for such events, valid business justification should exist.

For tax depreciation purposes, taxpayers receiving a contribution in kind of a business or organized part of a business generally should use the initial value of the fixed assets in the books of transferring party (the continuity principle). Special care should be taken if liabilities are included.

Contributed goodwill, knowhow and assets allocated to reserve capital cannot be depreciated for tax purposes.

The contribution in kind of a business or an organized part of business is not subject to VAT. A contribution of assets or rights is subject to VAT if the supply of such goods would be subject to VAT. An increase in share capital is subject to PCC at the rate of 0.5 percent (a share premium is not subject to PCC). By contrast, the contribution in kind of a business or an organized part of the business to a capital company is currently not subject to PCC.

Group relief/consolidation

Generally, each company is taxed on a stand-alone basis. A fiscal group can be created for corporate tax purposes, consisting of a Polish parent and its 75 percent Polish subsidiaries with an average qualified share capital per company of PLN500,000. The subsidiary companies cannot own shares in other companies that are members of the group.

An agreement must be signed by the members to form a fiscal group for at least 3 years. This should take the form of a notarized deed, which is then registered with the tax office. A fiscal group is regarded as one taxpayer. Losses arising before the group is formed cannot be offset against the group's profits.

A number of conditions need to be met. Operationally, the most significant requirement is that the taxable income of the group for tax purposes must be equal to at least 2 percent of gross taxable revenue.

Transfer pricing

The arm's length principle generally applies to transactions between related companies. The Organisation for Economic Co-operation and Development's (OECD) transfer pricing guidelines are followed in applying domestic transfer pricing legislation. The provisions apply to transactions between related parties in circumstances where the taxpayer does not carry out transactions on an arm's length basis. In these cases, the tax authorities have the right to adjust the level of declared income.

As of 1 January 2017, significant changes to the rules governing the relationships between related parties were introduced. In particular, the amendments imposed new transfer pricing reporting obligations and new criteria for the preparation and extent of transfer pricing documentation. The changes also increased the threshold for determining the existence of capital relations to 25 percent.

Taxpayers whose revenues or expenses in the year preceding the tax year exceed 10 million euros (EUR) are obliged to prepare a comparable analysis (benchmarking study), and those exceeding EUR20 million also have to prepare a master file. Further reporting requirements are imposed on domestic taxpayers whose consolidated revenue exceeds the equivalent of EUR750 million — they are required to prepare and submit to the tax authorities a report on the amount of income and tax paid and the places of business activity of its subsidiaries and foreign establishments.

A taxpayer may conclude an APA with the Minister of Finance to confirm the appropriateness of the taxpayer's transfer pricing policy. The purpose of an APA is to agree in advance on the arm's length nature of the terms of the transactions between related parties. APAs also cover the attribution of profit to PEs. Once an APA is concluded, the local tax authorities will not be able to question the arm's length nature of the covered transactions. As of 1 January 2018, restrictions on the deductibility of fees for intangible services do not apply to entities that have obtained an APA. At the end of January 2018, the Minister of Finance had concluded only 43 APA agreements. However, this number may rise in the future

as the government has announced plans to introduce a less formalized APA procedure for low value-adding services.

Foreign investments of a local target company

Poland recently amended CFC provisions — see 'Recent developments' above for details.

Comparison of asset and share purchases

Advantages of asset purchases

— The buyer may depreciate the assets acquired at market value. If goodwill arises (it is possible to acquire only part of the business) on assets under an asset deal, the price constitutes the depreciation base.

— The tax liabilities assumed by the buyer (for which they are jointly and severally liable with the seller) can be eliminated or limited if a special certificate is obtained from the tax authorities (where a business or organized part of a business is acquired, no such liability arises on purchases of single assets).

— If the purchase is funded by debt, the interest can be offset against the profits of the acquired business.

— Loss-making companies within the buyer's group can absorb profitable operations (or vice versa), reducing the effective tax rate.

— If the purchase is subject to VAT, the input VAT can be deducted.

— Where a business or organized part of the business is purchased, goodwill is subject to tax depreciation.

Disadvantages of asset purchases

— Possible need to renegotiate supplier agreements and employment contracts.

— Pre-acquisition losses and other tax attributes of the target company are not transferred with the business. They remain with the target company or are lost.

— Higher capital outlay is usually involved.

— Higher capital taxes if ongoing business is purchased (usually) or a cash flow disadvantage if the transaction is subject to VAT.

— Possible VAT clawbacks (if the transaction is VAT-exempt).

— May be unattractive to the seller, thereby increasing the price.

— Usually involves more formalities because each individual component needs to be transferred.

— Structure of transaction must be carefully examined; re-classification may trigger adverse tax consequences.

Advantages of share purchases

— Likely more attractive to seller, so the price is likely lower (if properly structured, no capital gains tax arises for the seller).

— Tax losses and other attributes of the target company can be used post-acquisition.

— May gain the benefit of existing supply and technology contracts.

— Lower capital taxes payable (usually).

— Not subject to VAT, so simpler and quicker to execute.

— Purchased company is not subject to taxation on the transaction.

Disadvantages of share purchases

— Liable for any claims or previous liabilities of the entity, including tax liabilities.

— No immediate deduction for the purchase price.

— More difficult to finance tax-efficiently.

— Lack of effective tax-consolidation means that post-acquisition integration with the buyer's existing Polish operations can be complex; no step-up on assets is possible.

— 1 percent PCC payable by the buyer on the acquisition but no recognition of tax-deductible goodwill.

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Portugal

Introduction

This report briefly describes the main tax issues that resident and non-resident entities may face in mergers and acquisitions (M&A) involving Portugal, from both inbound and outbound perspectives. The information in this report is based on the tax legislation in force as at 31 January 2018.

Recent developments

The State Budget Law for 2018 was published on 29 December 2017 and clarifies the government's intention to introduce some of the Organization for Economic Co-operation and Development's (OECD) recommendations on base erosion and profit shifting (BEPS).

The Portuguese State Budget Law for 2018 foresees the possible withdrawal some temporary tax benefits, as of 1 July 2018.

Whether the benefits will be withdrawn depends on the conclusions of a special commission analyzing the economic reasons for maintaining certain tax benefits currently in force. If the commission does not reach a conclusion by the end of June 2018, the tax benefits will automatically be revoked.

The State Budget Law for 2018 also introduced a new rule in the Portuguese Corporate Income Tax (CIT) Law taxing capital gains from the transfer of the share capital or similar rights in non-resident entities, where, at any time in the previous 365 days, the value of those shares or rights, is derived directly or indirectly, in more than 50 percent of real estate assets located in Portuguese territory.

Additionally, during 2017, Portugal signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS.

Asset purchase or share purchase

An acquisition in Portugal is usually conducted through the acquisition of shares in a company, rather than its assets, because an acquisition of assets often triggers real estate transfer tax and stamp duty for the buyer.

A share sale is also usually more efficient for the seller. Capital gains on the sale of shares may benefit from a full exemption in certain cases, whereas capital gains on a sale of assets are generally fully taxable or only partly exempt at the level of the seller.

Purchase of assets

An asset deal can be more attractive for the buyer than a share deal because of the non-transfer of tax contingencies faced by the target company, greater flexibility in funding options and the ability of the buyer to acquire only specific assets.

However, some features of an asset deal make it less tax-efficient, such as real estate transfer tax, stamp duty and the inability of transferring to the buyer eventual tax losses carried forward by the target company.

Purchase price

For tax purposes, the purchase price corresponds to the acquisition value agreed in the respective contract or the property tax value (for real estate assets), whichever is higher.

Transfer pricing rules must be complied with where the deal is undertaken between related entities. Under these rules, the acquisition value agreed between the parties must correspond to the value that would be agreed between non-related entities, in compliance with the arm's length principle.

Goodwill

The acquisition cost of certain intangible assets with no defined useful life period, namely, goodwill on the acquisition of a business unit (but not shares), can be amortized for tax purposes over a 20-year period.

Depreciation

According to the CIT Code, depreciation costs are allowed for tax purposes based on the rates set out in Regulatory Decree no. 25/2009, of 14 September 2009.

Land is not depreciable for tax purposes.

Tax attributes

No tax attributes, such as tax losses carried forward and tax incentives, are transferred to the buyer as part of an asset deal.

The limitation on transferring tax losses may be reduced by offsetting them against an eventual capital gain obtained by

the seller and the corresponding step-up in the acquisition value of the assets for the buyer.

Value added tax

According to the Portuguese Value Added Tax (VAT) Code, a sale of assets (or services) is considered a supply of goods (or services) subject to VAT.

However, the transfer of assets as a going concern, whether for consideration or not, or as a contribution to a company, is not subject to VAT, provided certain requirements are met.

This no-supply rule serves the purpose of simplicity and is aimed at preventing the successor from being overburdened with a large VAT payment, which can normally be recovered through the input VAT deduction.

Where the assets being transferred do not constitute a business unit, the transferred assets (or services) have their own VAT treatment because the seller is normally obliged to charge VAT on the goods (or services) that are being sold, such as stocks and movable goods.

For example, stocks that are sold or contracts that are assigned are normally subject to VAT at the standard rate, whereas the sale of, for example, real estate is VAT-exempt.

Where the recipient is not wholly liable to tax, the tax authorities may take measures to prevent distortion of competition and require VAT adjustments to prevent tax evasion or avoidance through the abuse of this rule.

Therefore, according to the VAT law, a seller that executes a VAT-exempt sale of real estate may be obliged to perform VAT adjustments in the VAT previously recovered.

To avoid these adjustments, the seller and buyer can jointly opt to waive this exemption and charge VAT on the transaction, provided certain requirements are met.

Where VAT is not charged, the operation is subject to stamp duty. Where the VAT exemption is waived, no stamp duty is applicable. Either way, any applicable real estate transfer tax is still due, unless a specific exemption applies (as mentioned below).

Transfer taxes

The purchase of assets comprising real estate located in Portuguese territory triggers real estate transfer tax and stamp duty on the acquisition value or the property tax value, whichever is higher. Rates vary from 5 to 6.5 percent[1] for real estate transfer tax. The stamp duty rate is 0.8 percent. Both taxes are borne by the buyer.

Some real estate transfer tax exemptions (total or partial) may be available for acquisitions of:

— urban properties in areas benefiting from incentives for less-developed inland areas that are permanently allocated to a company's activities

— property in areas of business location carried out by the respective management companies and by the companies that are located there

— assets for resale, where undertaken by a real estate company, provided the assets are re-sold within 3 years

— property for urban rehabilitation, provided that the construction work is initiated within 3 years.

Additionally, under certain circumstances, the transfer of assets as a going concern (*Trespasse*) may trigger stamp duty at the rate of 5 percent.

Purchase of shares

The purchase of shares is usually more attractive from a tax perspective for both the buyer (since it generally does not trigger real estate transfer tax or stamp duty) and the seller (since it facilitates access to a capital gains exemption).

However, a purchase of shares can give rise to significant disadvantages for eventual tax contingencies within the target company.

Therefore, a thorough investigation of the target is essential to identify any possible tax contingencies based on a review of tax returns, documents and procedures. Such a review should cover all taxes, including CIT, VAT, personal tax, stamp duty and social security contributions.

Tax indemnities and warranties

Under a purchase of shares, tax liabilities and claims are transferred with the target companies, although protection may be sought in the sale-purchase agreement or any formal letter signed by both parties.

Any future assessment by the tax authorities will continue to be claimed from the target company, so usually the buyer requests and the seller provides indemnities or warranties regarding any undisclosed tax liabilities of the target company.

The Portuguese tax law operates a system of self-assessment under which companies are subject to periodic tax audits by the tax authorities for most taxes, after which tax assessments can be raised in respect of the preceding 4 fiscal years. Until this period has expired, tax returns are not closed but remain open for review and inspection.

Where companies have tax losses, the period open to fiscal audits may be extended to the period during which the tax losses can be carried forward.

[1] The Real Estate Transfer Tax Code establishes that the tax rate is always 10 percent (and no exemption or reduction applies) when the buyer has its residence or head office in a country with a favorable fiscal regime, as defined by an order issued by the Ministry of Finance.

For social security purposes, a tax audit and assessment may be carried out for the preceding 5 fiscal years. Real estate transfer tax and stamp duty on the acquisition of real estate are open for tax audit and assessment for 8 years.

Tax losses

In Portugal, tax losses may be offset against taxable profits assessed for 5 subsequent years (the carry forward period is 5 fiscal years for tax losses assessed in 2013 fiscal year; and 12 fiscal years for tax losses assessed in 2014 to 2016).

The deduction of tax losses is limited to 70 percent of the taxable profit annually.

The deductibility of tax losses is restricted where there is a change of ownership of more than 50 percent of the share capital of a company or of most of its voting rights, although several exceptions may apply.

In this case, the utilization of tax losses carried forward requires pre-authorization from the tax authorities in response to a request filed by the company in advance, explaining its economic reasons. The Portuguese tax authorities do not automatically approve such requests; they are analyzed case-by-case.

Pre-sale dividend

Portuguese tax law has no specific rules for the distribution of a pre-sale dividend.

Under Portuguese tax law, dividends paid by a Portuguese subsidiary to a non-resident entity are subject to withholding tax (WHT) at a flat rate of 25 percent, which may be reduced by a tax treaty (for entities resident in tax havens, the rate is increased to 35 percent). The Portuguese CIT Code foresees a CIT exemption (and thus no WHT obligation) for dividends distributed by Portuguese-resident companies to entities resident in a country:

— of the European Union (EU) or European Economic Area (EEA)

— bound to an administrative cooperation mechanism similar to the one established in the EU, or

— with which Portugal has entered into a tax treaty and such agreement foresees a similar administrative cooperation agreement to the one above.

The exemption also depends on the following:

— The non-resident shareholder is subject to and not exempt from one of the income taxes referred in article 2 of the EU Parent-Subsidiary Directive or an income tax that is similar to the Portuguese CIT, as long as the statutory tax rate applicable is not lower than 60 percent of the Portuguese CIT rate, which is currently 21 percent.

— The non-resident shareholder holds directly, or directly and indirectly, a participation in the Portuguese company's share capital or voting rights of at least 10 percent and has held that participation continuously during the 12 months preceding the dividend distribution.

— The ownership structure was set up for valid economic reasons, and not for the purpose of obtaining a tax advantage. The Portuguese entity that makes the dividend distribution complies with the reporting obligations regarding the effective beneficiary of the income.

A global participation exemption regime has been adopted for dividends obtained by Portuguese entities, excluding those obtained from tax havens, provided the following requirements are met:

— The beneficiary holds at least 10 percent of the share capital or voting rights, and the participation has been continuously held throughout the year prior to the distribution of the profits or is maintained during that period.

— The company distributing the profits is not exempt from CIT and is subject to a tax referred to in the EU Parent-Subsidiary Directive or similar tax whose rate is not lower than 60 percent of the CIT rate, or, where this requirement is not met, where most of its profits are derived from a business activity or its assets are not qualified as portfolio investments.

Participation exemption regime for capital gains

Under the participation exemption regime for capital gains, and subject to the same conditions as the participation exemption regime for dividends, capital gains and losses assessed by a Portuguese company from the sale of shares are not taxable or deductible unless more than 50 percent of the assets of the company whose shares are being sold is composed of real estate assets located in Portugal and held for resale.

Transfer taxes

Although real estate transfer tax is generally not due on a share deal, the Portuguese Real Estate Transfer Tax Code states that the acquisition of a private limited liability company (Lda.) holding real estate that implies a single shareholder owning a participation of at least 75 percent is subject to real estate transfer tax.

In this case, the Real Estate Transfer Tax Code establishes that the tax base is the higher of:

— the property tax value

— the book value of the assets, as stated in the company's balance sheet.

The real estate transfer tax is due by the buyer of the share capital and must be paid before registering the public deed of acquisition.

The tax rate varies from 5 to 6.5 percent (normally 6.5 percent).

This tax is not due on transactions of public limited liability companies (S.A. companies).

No stamp duty is due on a purchase of shares.

Real estate transfer tax is due on the acquisition of participation units from private subscription closed-ended real estate investment funds and on operations (e.g. increase or reduction of capital), provided the outcome of the operations is that one holder, or two holders who are married or unmarried partners, will dispose of at least 75 percent of the participation units representing the fund's assets.

Where the fund is dissolved and all or some of its immovable assets become property of one or more unit holders whose assets have already been taxed, the tax will be payable on the difference between the value of the assets acquired and the amount of tax previously paid. Additionally, the real estate transfer tax base is the property tax value corresponding to the majority unit holding, or the total value of those assets, according to each case. In both cases, however, the value of the managing company's asset report will be considered if that value is if the higher.

Similarly, real estate transfer tax is payable on:

— transfers of immovable property by the unit holders on the subscription of participation units in private subscription closed-ended real estate investment funds

— allocations of immovable property to unit holders as a participation unit refund on liquidation of a private subscription closed-ended real estate investment fund.

In these cases, the real estate transfer tax base is the higher of the property tax value and the value at which the property became one of the fund's assets.

Choice of acquisition vehicle

The choice of the acquisition vehicle largely depends on the nature of the transaction (asset or share deal), the nature of the assets involved, the financing structure and the nature of the income to be extracted from the target company.

The following vehicles may be used in an acquisition of shares or assets:

— Portuguese holding company

— foreign parent company

— non-resident intermediate holding company

— Portuguese branch

— joint venture.

Local holding company

Under Portuguese law, a Portuguese pure holding company (*Sociedade Gestora de Participações Sociais* — SGPS) is incorporated as a regular company (S.A. or Lda.) but has a specific social purpose in its articles of incorporation restricted to the holding and management of share capital participations.

As such, an SGPS company is subject to the same tax obligations and the same tax regime as a regular company.

Foreign parent company

Where the Portuguese subsidiaries are held by a foreign parent company, the corresponding tax implications vary significantly, depending on the country in which the parent company is resident.

Apart from differences among Portugal's tax treaties with other countries, there are significant differences in the tax treatment depending on whether the parent company is located in or outside the EU, EEA or treaty country where the treaty foresees the same administrative cooperation (see 'Pre-sale dividend' earlier in this report).

Where the parent company is located in the EU (or the other mentioned territories), in addition to the possibility of reduced WHT rates under tax treaties, the parent company may also benefit from a WHT exemption on dividends (see 'Pre-sale dividend').

The parent company only benefits from reduced WHT rates where the corresponding country has signed a tax treaty with Portugal.

Portugal's tax treaties generally do not entitle Portugal to tax capital gains on the sale of shares in a Portuguese company. Even where a treaty allows Portugal to tax the capital gain, a foreign parent company (EU-resident or not) may benefit from an exemption on capital gains on the sale of share capital participations in Portuguese-resident companies unless:

— The parent company is owned, directly or indirectly, in 25 percent or more by a Portuguese tax-resident entity.

— The parent company is resident in a tax haven jurisdiction.

— More than 50 percent of the assets directly or indirectly held by the Portuguese company consist of real estate property located in Portugal.

Local branch

A branch of a foreign company is subject to Portuguese CIT on its attributable income at the rate of 21 percent. In addition, a state surcharge applies to the part of the taxable profit exceeding 1.5 million euros (EUR) as follows:

— from EUR1.5 million to EUR7.5 million — 3 percent

— from EUR7.5 million to EUR 35 million — 5 percent (on the part exceeding EUR 7.5 million)

— more than EUR35 million — 9 percent.

This taxation may be increased by a municipal surcharge of up to 1.5 percent levied over the taxable income, giving rise to a maximum standard CIT rate of 31.5 percent. There is no WHT on distributions to the foreign head office.

A commercial disadvantage of a branch may be that the branch is not a separate legal entity, leaving the head office fully exposed to the liabilities of the branch. Additionally, the tax authorities may deny the deduction of interest charged or allocated to the branch by the head office, depending on the circumstances.

Under Portuguese tax law, profit distributions have the same treatment as in a Portuguese company when made to and received by a Portuguese permanent establishment of a parent company located in the EU, EEA or treaty country where the treaty foresees the same administrative cooperation, as discussed in this report's earlier section on pre-sale dividends.

Joint ventures

Generally, joint ventures are set up as regular Portuguese companies held by the joint venture partners.

Choice of acquisition funding

Funding is critical to the success of a transaction. The mix of debt and equity and the type of debt may have a significant tax impact under Portuguese law, as summarized below.

Debt

Apart from WHT on interest, financing operations undertaken within a group with Portuguese-resident companies may also trigger significant tax charges under stamp duty.

Although exemptions may apply, the costs of setting up stamp duty-efficient debt structures may exceed the related tax savings.

Earnings-stripping rules

Generally, interest costs are deductible for tax purposes, provided they are considered necessary for generating taxable income or undertaking the company's activity.

According to the earnings-stripping rules, the deductibility of net financing expenses (interest and other) is limited to EUR1 million or 30 percent of earnings before net interest, taxes, depreciation and amortization (EBITDA), whichever is higher.

Any amounts of net interest and other financing expenses that exceed the applicable limit (and are not tax-deductible) may be carried forward and offset against the taxable profit of the following 5 years, together with the net interest and other financing expenses of that year, to the extent they do not exceed both limits.

In addition, where the net interest and other financing expenses deducted for tax purposes do not exceed 30 percent of the EBITDA, the part of the limit that was not exceeded can be considered for the purposes of increasing the limits applicable in the following 5 years. The limits foreseen in the transitional period are not relevant for this purpose.

Where the group relief regime applies, this limitation could be applied to the group's EBITDA, provided certain requirements are fulfilled.

For companies taxed under the group taxation relief that have opted to calculate the earnings-stripping limit on a consolidated basis, such limits must be calculated based on the sum of the EBITDA of all the companies that are a part of the tax group.

Transfer pricing

Under transfer pricing rules, interest charged between related entities must be agreed under the same conditions as those agreed between entities that do not have a special relationship.

See 'Transfer pricing' under 'Other considerations' later in this report.

Transfer taxes

Stamp duty is levied on the use of credit, in any form, at rates that vary according to the maturity of the loan, as follows:

Credit maturity	Rate
Less than 1 year	0.04 percent (per month or part month)
1 or more years	0.5 percent
5 or more years	0.6 percent

Source: KPMG in Portugal, 2018

Credit in the form of a current account, bank overdraft or any other form in which the maturity is not determined or determinable is subject to stamp duty at a rate of 0.04 percent on the average monthly balance, calculated by dividing the sum of the daily debt balance by 30.

Stamp duty also applies at the rate of 4 percent on interest charged by credit institutions, financial companies or other financial entities.

Some exemptions from stamp duty may be available, for example, on shareholder loans where the parties establish an initial period of no less than 1 year during which no reimbursement occurs.

Bonds and commercial paper

Bonds and commercial paper are not subject to stamp duty, in compliance with the Council Directive 69/335/EEC of 17 July 1969 on indirect taxes on the raising of capital.

Deductibility of interest

Interest charged to Portuguese-resident companies is generally deductible for tax purposes, provided the loan is related to the

company's activity, the earnings-stripping rules are observed, and, where granted by related entities, the interest complies with limitations under the transfer pricing rules.

Withholding tax on trust and methods to reduce or eliminate it

WHT on interest applies at a rate of 25 percent, which may be reduced under a tax treaty or by applying the provisions of the EU Interest and Royalties Directive. No WHT applies to interest on loans granted by a non-resident financial institution to a Portuguese-resident credit institution.

WHT exemptions may apply to interest charged on bonds, provided certain requirements are met.

Checklist for debt funding

— Interest expenses are deductible for tax purposes, provided they are incurred in order to obtain taxable income, although the earnings-stripping rules may limit deductibility.

— Compliance with the transfer pricing rules where the funding occurs between related parties.

— Relief for WHT on interest may be obtained under a tax treaty (partial) or the EU Interest and Royalties Directive (full).

— To benefit from stamp duty exemptions regarding the principal amount and/or the interest, the intervening entities should carefully address the nature of the financing, the existing lender-borrower relationship and the repayment period.

Equity

Portuguese resident companies are entitled to a deduction of 7 percent of the share capital corresponding to cash contributions of the shareholders for incorporating the company or increasing its share capital.

As of 2018, contributions in kind resulting from the conversion of shareholder loans are also eligible for this tax benefit, provided certain requirements are met.

Dividends

Dividends paid by a Portuguese subsidiary to a non-resident entity are subject to WHT at a flat rate of 25 percent, which may be reduced under a tax treaty signed by Portugal.

In addition, no WHT applies if, among other conditions, the parent company has held a minimum of 10 percent of the share capital of the Portuguese affiliate for at least 12 months.

Where the minimum holding period is not met at the time the dividends are distributed, the parent company can file a reimbursement claim with the Portuguese tax authorities within 1 year from the end of the minimum holding period.

Reorganizations

As a result of the transposition of the EU Merger Directive, the Portuguese tax law foresees a special tax neutral regime for certain operations performed as part of group reorganizations. Among other conditions, this regime only applies to operations performed for sound economic reasons (i.e. that do not have tax avoidance as their sole or main purpose).

The operations discussed in the following sections may qualify for the special tax neutrality regime.

Merger (*fusão*)

A merger qualifying for tax neutrality occurs in the following circumstances:

— where one or more companies transfer all their assets and liabilities to another existing company in exchange for the issue to their shareholders of shares representing the share capital of that other company and, where applicable, a cash payment not exceeding 10 percent of the nominal value of the shares attributed or, in the absence of a nominal value, the accounting par value of those shares

— where one or more companies transfer all their assets and liabilities to a company to be incorporated in exchange for the issue to their shareholders of shares representing the share capital of that new company and, where applicable, a cash payment not exceeding 10 percent of the nominal value of the shares attributed or, in the absence of a nominal value, the accounting par value of those shares

— where a company transfers all its assets and liabilities to the company holding all the shares representing its share capital

— where a company transfers all its assets and liabilities to another existing company and both companies have the same shareholder

— where a company transfers all its assets and liabilities to another company and the share capital of the latter is entirely held by the former (downstream merger).

Demerger (*cisão*)

A demerger qualifying for tax neutrality may take one of the following forms:

— simple demerger, whereby a company, without being extinguished, transfers one or more business units (keeping at least one business unit) to a new company, in exchange for the pro rata issue to its shareholders of shares representing the share capital of the new company, and, eventually, a cash payment not exceeding 10 percent of the nominal value of the shares or, in the absence of a nominal value, the accounting par value of those shares

— demerger/merger, whereby a company, without being dissolved, transfers one or more business units (keeping at least one business unit) to an existing company, in exchange for the pro rata issue to its shareholders of shares representing the share capital of the new company, and, eventually, a cash payment not exceeding 10 percent of the nominal value of the shares or, in the absence of a nominal value, the accounting par value of those shares

— demerger-dissolution, whereby a company, on being dissolved, transfers its assets and liabilities to two or more companies to be incorporated or to merge them with existing companies or with assets and liabilities of companies divided by similar processes and with the same purpose, in exchange for the pro rata issue to its shareholders of shares representing the share capital of the existing companies or of the new companies and, eventually, a cash payment not exceeding 10 percent of the nominal value of the shares attributed or, in the absence of a nominal value, the accounting par value of those shares.

Other demergers may be carried out under the tax neutrality regime whereby:

— a company transfers one or more business units (keeping at least one business unit) to its single shareholder

— a company transfers one or more business units (keeping at least one business unit) to another existing company and both companies have the same shareholder

— a company transfers one or more business units (keeping at least one business unit) to another company and the share capital of the latter is entirely held by the former.

Contribution in kind (*entrada de activos*)

A contribution in kind is an operation whereby a company transfers, without being dissolved, all or one or more business units to another company in exchange for shares representing the share capital of the company receiving the business unit(s).

Exchange of shares (*permuta de partes sociais*)

An exchange of shares is an operation whereby a company acquires a share capital participation in another company, which grants it the majority of the voting rights in that company, or whereby a company already owning the majority of the voting rights acquires a new participation in the same company in exchange for the issue to the shareholders of the latter company, in exchange for their shares, of shares representing the share capital of the former company and where applicable, a cash payment not exceeding 10 percent of the nominal value of those shares or, in the absence of a nominal value, the accounting par value of the shares issued in exchange.

For the purposes of the special tax neutrality regime, a 'business unit' is defined as all the assets and liabilities of a division of a company that, from an organizational point of view, constitute an independent unit; that is, an entity capable of functioning by its own means.

The above-noted operations involving non-Portuguese EU-resident companies may also benefit from the special tax neutrality regime, subject to the fulfillment of certain conditions.

Hybrids

The current Portuguese tax law does not include rules for hybrids. The law was amended to disregard, for tax purposes, reclassifications made for accounting purposes. However, the amended law does not stipulate how the income arising from such financing instruments should be treated for tax purposes.

Discounted securities

Under Portuguese tax law, expenses associated with the issue of discounted securities, such as bonds, are tax-deductible, provided they are incurred in order to obtain taxable income.

Under Portuguese tax law, expenses associated with the issue of discounted securities, such as bonds, are tax-deductible, provided they are essential for realizing profits and gains subject to CIT or for maintaining the production source.

Because discounted securities correspond to non-interest-bearing money market instruments issued at a discount and redeemed at maturity for full face value, a company's income on the securities' maturity is subject to CIT at a rate of up to 31.5 percent.

Deferred settlement

Where settlement of the consideration is deferred, the buyer should address the following issues:

— Where the transaction involves related parties, interest may have to be charged over the deferral period to comply with the transfer pricing rules.

— Where the deferral period is significant, there is a risk that the deferred consideration will be deemed as a financing and thus subject to stamp duty.

Other considerations

Concerns of the seller

The possibility of achieving capital gains exemption leads most sellers to prefer a share deal over an asset deal.

Company law and accounting

The Portuguese Commercial Companies Code sets out the conditions under which a merger, demerger and contribution in kind can take place.

The code creates a simplified merger regime for situations involving a company wholly owned by the merging company. This regime has been extended to include situations involving minority shareholders (holding a maximum of 10 percent of the shares of the company being merged). Several legal procedures are waived for the intervening entities, thereby simplifying the bureaucratic process.

In this regard, the new Portuguese generally accepted accounting principles (GAAP) establish that, where the cost of a merger for the merging company at fair market value is higher than the net assets of the merged company, the difference must be allocated to the assets and liabilities transferred that can be identified.

However, this type of imputation is not accepted for tax purposes.

Currently, Portuguese GAAP requires that any difference between the net assets being merged and the value of the share capital participation held by the merging company in the company being merged should be accounted for as a merger reserve and included in an equity account.

The adoption of International Financial Reporting Standards (IFRS) for Portuguese tax purposes has not changed the tax treatment of mergers, demergers, contributions in kind or exchanges of shares.

Group relief/consolidation

A qualifying group for the group relief regime consists of a parent company holding, directly or indirectly, a share capital participation of at least 75 percent in one or more subsidiaries, provided that the participation represents more than 50 percent of the voting rights.

The following main conditions must also be met:

— The parent company did not waive the application of this regime in the previous 3 years.

— The parent company is not owned by another Portuguese-resident company also qualifying as parent company under the group relief regime.

— The share capital participation was held for more than 1 year prior to the beginning of the application of the regime. This requirement does not apply to companies incorporated by the parent company where the participation has been held since the date of incorporation.

— The registered head office and effective place of management of the parent company and its subsidiaries are in Portuguese territory.

Companies indirectly held by the parent company through companies resident in the EU or EEA also qualify for the 75 percent shareholding requirement.

For the regime to apply, the parent company must notify the tax authorities of its adoption. The regime remains valid indefinitely where there are no changes in the group that trigger its cessation.

The tax group cannot include companies that:

— have tax losses carried forward in the 3 years prior to the start of the regime, except where the share capital participation is held by the parent company for more than 2 years

— are inactive for more than 1 year or have been dissolved

— are in a bankruptcy or judicial recovery procedure

— are subject to a more favorable CIT rate and have not waived this benefit

— have a tax year different from that of the parent company

— do not assume the legal form of an Lda. company, S.A. company or partnership by shares.

The group's taxable profit is determined by adding together each company's tax result, thereby obtaining an aggregated taxable profit or loss.

The above-noted waiver of a lower CIT rate in order to apply the higher standard rate must be kept for a minimum period of 3 years.

Intragroup dividends, interest and royalties paid among the companies of the group are not subject to WHT, provided this income relates to periods during which the group relief regime is in force.

The regime ceases to apply whenever any of the necessary requirements are not met or the tax authorities assess the taxable income of any company of the group companies through indirect methods (applied in exceptional cases when the accounting records of the company are not considered as reliable).

Where the parent company ends up being held by another company that qualifies as the parent company of the group, the latter may opt for the continuation of the regime, provided the tax authorities are informed by the end of third month of the fiscal year following the inclusion of the new parent company.

The application of the group taxation relief is also possible if the parent company is resident for tax purposes in an EU or EEA member state.

On termination of the regime, all unused tax losses generated while the regime was in force are lost.

Transfer pricing

Arm´s length principle

The Portuguese transfer pricing rules follow the OECD guidelines.

The arm´s length principle applies both to domestic and cross-border commercial and financial transactions established with related entities.

The term 'related entity' is defined widely for this purpose. According to number 4 of article 63 of the CIT Code, special relationships are deemed to exist between two entities when one entity has or may have, directly or indirectly, a significant influence over the management of another entity, including:

— an entity and the shareholders of the respective share capital or voting rights, or their spouses, ascendants or descendants, who hold directly or indirectly, a stake of not less than 20 percent of the capital or voting rights

— entities in which the same shareholders or their spouses, ascendants or descendants, hold directly or indirectly, a stake of not less than 20 percent of the capital or voting rights

— entities whose legal relationship allows, by its terms and conditions, the control of the management decisions of the other, arising from facts outside the commercial or professional relationship itself

— transactions between a resident entity and entities resident in a clearly more favorable tax regime (as listed in Ministerial Order n.º 292/2011, November 8)

— other situations.

The transfer pricing rules apply also to transactions between a permanent establishment located in the Portuguese territory and its foreign headquarters or other foreign permanent establishments, and to transactions between resident entities in Portugal and all its permanent foreign establishments and among its permanent establishments.

Taxpayers must evaluate and prepare their transfer pricing documentation on a contemporaneous basis.

Year-end adjustments and adjustments to the taxable income by taxpayers are limited to certain situations related to positive transfer pricing adjustments in cross-border transactions.

Pre- and post-restructuring value contribution analysis, procedures review and market profitability tests are crucial to evaluate the impact of the business model reorganization and assess, define and implement a consistent and robust group pricing policy. An analysis of the economic benefit, the non-duplication of activities and the pricing model is usually conducted during a tax audit.

Documentation and other declarative obligations

Corporate taxpayers that have recorded an annual total net sales and other income equal to or greater than EUR3 million, in the previous fiscal year, are required to prepare and maintain contemporaneous transfer pricing documentation supporting the arm's length nature of their transactions (commercial, financial or others) with related parties.

Documentation should comprise the following information:

— description of the group's business strategy, identifying aspects susceptible to influencing the conduct of the taxpayer´s activity

— description of the macroeconomic environment and its impact on the taxpayer's activity

— description of the group's value chain contribution, as well as a functional and risk analysis of the taxpayer and its related entities for the controlled transactions

— identification, description and quantification of the controlled transactions, for the last 3 years, including the description of the pricing methodology associated with those transactions

— the selection of the most appropriate transfer pricing method for the controlled transactions, the respective economic analysis, its results and supporting information.

Portugal has not yet adopted the Action 13 documentation structure (master file, local file and exchange of certain data), although Portugal follows the Code of Conduct on Transfer Pricing Documentation.

Under the Portuguese transfer pricing regime, taxpayers must also disclose the following information on their Annual Tax and Accounting Return (IES):

— amounts of related-party transactions, per transaction category, for both domestic and cross-border transactions

— the transfer pricing methods applied to their cross-border transactions

— whether documentation was compiled when filing the income tax return.

The IES is due by the 15th day of the 7-month period following the tax year-end.

Advance pricing agreements

Unilateral, bilateral and multilateral advance pricing agreements (APA) are available.

The submission of the request at the preliminary phase is free of charge. The submission of the proposal entails a fee that may vary from approximately EUR3,150 to EUR35,000, depending on the taxpayer's revenue.

Renewals or reviews of APAs require a filing fee, calculated in a similar way, but with a discount of 50 percent of the initial fee.

Mandatory automatic exchange of information

Country-by-country reporting

Portugal has signed the Multilateral Competent Authority Agreement for the exchange of tax information, which follows

Action 13 of the OECD BEPS project. Portugal has signed several qualifying competent authority agreements with other jurisdictions that enable the exchange of country-by-country (CbyC) reports.

This obligation applies to multinational enterprises with annual consolidated group revenue equal to or exceeding EUR750 million in the previous year. The regulations extend to subsidiary entities.

The CbyC report is a requirement for the ultimate parent entity of a multinational group, as well as for an entity resident in Portugal, owned or controlled by one or more non-resident entities not covered by a similar obligation or if a qualified agreement between the competent authorities is not in force at the date of submission, or if a systemic failure occurs in the tax residence of the ultimate parent entity. When more than one constituent entity exists, the multinational group may appoint any of them as the reporting entity.

The CbyC reporting requirement applies for fiscal years beginning on or after 1 January 2016. The secondary local filing requirement for non-parent constituent entities in Portugal applies for fiscal years beginning on or after 1 January 2017. The surrogate parent entity option is not applicable in Portugal.

Taxpayers need to notify the tax authorities by the last day of the 5th month following the fiscal year of the identification and the country or tax jurisdiction of the reporting entity (Form 54).

The CbyC report must be filed electronically no later than 12 months after the last day of the entity's accounting period. The Ministerial Order 383-A/2017 of 21 December 2017 approved the form and instructions for meeting the CbyC reporting requirement (Form 55).

CbyC reports must be filed in Portuguese language. The OECD's XML Schema standardized electronic format is mandatory for fiscal year 2016. Alternatively, for the following years, the CbyC report (Form 55) can be submitted electronically.

Other

Mandatory automatic exchange of information is also required for cross-border tax rulings and APAs issued, amended or renewed in the national territory. The information to be reported to the competent authorities of all the member states and to the European Commission, includes (among other things) the identification of the company, a summary of the tax rulings and/or the APAs, the expiration date of the tax rulings or APAs and the amount(s) of the cross-border transaction(s).

Transfer pricing audit and penalties

Recent audits have focused more on adjusting operating losses (disregarding the effect of the recent global economic crisis), payment for intragroup services, financial transactions, intangible property transactions and business restructuring processes.

The latest strategic plans against fraud and tax evasion foresee the reinforcement of transfer pricing audits, the increase of the number of technicians assigned to the transfer pricing department, as well as the application of anti-abuse rules.

Penalties of up to EUR10,000 apply for not complying with the reporting requirements of the transfer pricing documentation, failing to provide the CbyC report, or filing to file a notification, plus a 5 percent increase per day of delay. Failing to submit the transfer pricing documentation is subject to a penalty of up to EUR150,000.

Transfer pricing adjustments are regulated by the general tax penalty regime. If an adjustment is sustained, general penalties may be assessed from EUR375 to EUR45,000. Compensatory interest for late payment is accrued at 4 percent monthly.

Dual residency

Under Portuguese tax law, a company qualifies as tax-resident where its headquarters or place of effective management is located in the Portuguese territory.

Portugal's tax treaties include rules to avoid situations of dual residency. In the experience of KPMG in Portugal, no issues have been raised by the Portuguese tax authorities with regard to dual residency.

Foreign investments of a local target company

The Portuguese tax law attributes profits obtained by foreign companies resident in tax haven jurisdictions to a Portuguese-resident entity where it holds, directly or indirectly (even where through an agent, trustee or intermediary), at least 25 percent of the share capital of the foreign companies. This percentage is reduced to 10 percent where the company located in a tax haven is held, directly or indirectly (even where through an agent, trustee or intermediary), more than 50 percent by Portuguese-resident entities.

This anti-avoidance rule is not applicable (among other situations) where:

— the non-resident entity is resident for tax purposes in an EU or EEA member state (provided the state is bound to provide administrative cooperation on taxation equivalent to the one that exists within the EU)

— the entity is set up and maintained for valid economic reasons

— the entity primarily carries on an agricultural, commercial, industrial or services activity.

Comparison of asset and share purchases

Advantages of asset purchase

— Possible to acquire a specific part of a company.

— Deductibility of higher depreciation costs in most cases.

— No previous (tax) liabilities of the company are inherited.

— Greater flexibility in funding options.

Disadvantages of asset purchase

— Possible need to renegotiate supply, employment and technology agreements.

— May be unattractive to the seller because of capital gains taxation, thereby increasing the price.

— May be subject to transfer taxes and stamp duty.

— May constitute a VAT event.

— Certain items are not depreciable (e.g. goodwill, although goodwill related to assets acquired as from 1 January 2014 can be deducted for tax purposes, in equal parts, during the first 20 tax years following its initial accounting register).

— Accounting profits may be affected by the creation of acquisition goodwill.

— Benefit of tax losses incurred by the target company remains with the seller.

Advantages of share purchase

— May benefit from existing supply or technology contracts.

— More flexibility to achieve capital gains exemption for the seller, thereby reducing the price.

— Not subject to transfer tax in most cases.

— Buyer may benefit from tax losses of target company (subject to limitations).

Disadvantages of share purchase

— Transfer of outstanding claims and possible hidden liabilities.

— No deduction for purchase price.

— Less flexibility in funding options.

KPMG in Portugal

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Romania

Introduction

This report addresses three fundamental decisions that face a prospective buyer undertaking a merger and acquisition (M&A) transaction from a Romanian perspective:

— What should be acquired: the target's shares or its assets?

— What will be the acquisition vehicle?

— How should the acquisition vehicle be financed?

Company law governs the legal form of a transaction, and accounting issues are also highly relevant when selecting the optimal structure. These areas are outside the scope of the report, but some of the key points that arise when planning M&As in Romania are summarized later in the report.

Asset purchase or share purchase

In Romania, an acquisition usually takes the form of a purchase of the shares of a company, as opposed to its business and assets (although the number of asset deals is increasing). The benefits of asset acquisitions for the buyer should not be ignored, particularly given that a step-up in the value of the assets can be recovered through depreciation (subject to specific considerations). Some of the tax considerations relevant to each method are discussed later in this report. The relative advantages are summarized at the end of the report.

Purchase of assets

A purchase of assets usually results in an increase in the base cost of those assets for both capital gains tax and capital allowances purposes, although this increase is likely to be taxable to the seller. However, goodwill is not recognized for tax purposes in Romania. In addition, historical tax liabilities generally remain with the company and are not transferred with the assets.

In principle, where the seller is declared insolvent (due to unpaid debts to the state), the buyer may be held liable for such debts where the insolvency was caused by the transfer of assets.

Purchase price

Where the transfer takes place between related parties and at below market value, there is a technical risk of a transfer pricing adjustment.

Goodwill

As noted above, amortization of goodwill is not tax-deductible.

Depreciation

Fixed assets purchased are usually booked at their acquisition cost and depreciated for tax purposes over their remaining useful life. Where assets are acquired for which the history is unknown or that have exceeded their normal life, new useful life must be established by a technical committee or expert. The useful lives of each category of assets are set by the government.

Tax attributes

Tax losses are not transferred on an asset acquisition. They remain with the company or are extinguished.

Value added tax

Valued added tax (VAT) is levied at the rate of 19 percent on a large number of goods and services, although goods dispatched outside Romania are not subject to VAT. The transfer of a business as a going concern is outside the scope of VAT, provided certain conditions are met.

Transfer taxes

Transfers of real estate may result in land/building registry taxes and notary fees of about 1 percent of the value of the transaction.

Purchase of shares

Where shares of a company are purchased, there is no change in the base value of its assets for tax purposes (i.e. no step-up in tax depreciation basis).

Capital gains derived by non-residents from a sale of shares are generally subject to 16 percent tax. However, an exemption may apply, provided that certain conditions are fulfilled (e.g. minimum 10 percent shareholding, minimum 1-year holding period, tax residency of the seller in a state with which Romania has concluded a double tax treaty).

Tax indemnities and warranties

In a share acquisition, the buyer is taking over the target company together with all related liabilities, including

contingent liabilities. Therefore the buyer normally requires more extensive indemnities and warranties than in the case of an asset acquisition.

Where significant sums are at issue, it is customary for the buyer to initiate a due diligence exercise, which would normally incorporate a review of the target's tax affairs.

Tax losses

Tax losses may be offset against future profits for a maximum of 7 years. There is no withdrawal of the tax losses carry forward right on a change of ownership or activity. Tax losses can only be carried forward, not back.

Tax losses recorded by companies that cease to exist due to a merger or demerger operation may be recovered by newly established taxpayers or by those that take over the assets of the absorbed or spin-off company, as applicable, proportional to the assets and liabilities transferred to the beneficiary legal entity, according to the merger/spin-off project.

Where a taxpayer does not cease to exist as a result of a transfer of part of its assets, the fiscal loss, transferred as a whole, is recovered by the taxpayer itself or by those that partially take over the assets of the transferring company, as applicable, proportional to the assets and liabilities transferred to the beneficiary legal entity, according to the merger/spin-off project or proportional to those maintained by the legal entity.

Pre-sale dividend

In certain circumstances, the seller may prefer to realize part of the value of their investment as income by means of a pre-sale dividend because the dividend may be subject to no or only a low effective rate of Romanian tax. This reduces the proceeds of the sale and thus any gain on the sale, which may be subject to a higher rate of tax.

Generally, a 5 percent dividend tax rate applies on dividends paid to non-residents (whether individuals or companies).

However, dividend payments made by a resident legal entity to an EU legal entity may be tax-exempt (subject to conditions, e.g. minimum 10 percent shareholding, minimum 1-year holding period).

Tax on dividends also may be reduced where payments are made to a company in a country or jurisdiction with which Romania has a tax treaty. Romania has concluded approximately 85 tax treaties with other countries/ jurisdictions.

Transfer taxes

Trade registry fees are due on the issue of share capital by a resident company or on registration of ownership of shares, but these fees do not depend on the value of the share capital and are modest (less than 1,000 euros (EUR)).

Choice of acquisition vehicle

Most foreign investors carry out business in Romania via either joint stock or limited liability companies.

Joint stock companies involve more extensive and formalized corporate governance structures than limited liability companies (e.g. more requirements for audit and board oversight). Therefore, a joint stock company generally is a suitable legal form for a business with a dispersed shareholder base. Only a joint stock company may be listed on a Romanian stock exchange.

For closely held businesses, the limited liability company is usually more suitable because of its simpler corporate governance structure and thus lighter administrative operating burden.

Investment via branches or unincorporated, tax-transparent entities (e.g. associations in participation) has the advantage of not being liable for tax on profits paid to the head office or shareholders/partners.

Local branch

As an alternative to the direct acquisition of the target's trade and assets, a foreign buyer may structure the acquisition through a Romanian branch.

A branch is an extension of its parent company, so it has no legal personality and no financial independence. Where a foreign company has a branch in Romania, the foreign company may be held liable to any creditors of the branch, including employees, for any debts and obligations incurred by the branch. A branch may undertake only those activities that its parent company has been authorized to carry out under its constitutional deed.

Romanian branches of foreign companies are subject to Romanian corporate tax on their profits.

Joint venture

Romanian law provides for various forms of business partnerships ('tax transparent entities'), with particular legal and tax regimes. Such business partnerships may consist of two or more partners (individuals or legal entities). Special requirements in the law for partnerships may apply, depending on the agreement between partners, the tax residence of the partners (foreign or Romanian) and other matters.

From a tax perspective, the profits derived from an association are generally subject to 16 percent tax (either corporate tax, personal income tax or WHT).

The tax treatment of associations depends on the nature of the particular association and needs to be carefully investigated before implementation.

Choice of acquisition funding

A buyer using a Romanian acquisition vehicle to carry out an acquisition for cash needs to decide whether to fund the vehicle with debt, equity or a hybrid instrument combining characteristics of both. The principles underlying these approaches are discussed below.

Note that company law includes specific restrictions on financing the acquisition of shares in certain types of companies by third parties.

Debt

The principal advantage of debt is the potential tax-deductibility of interest (see 'Deductibility of interest'). Another potential advantage of debt is the deductibility of expenses, such as guarantee fees or bank fees, in computing trading profits for tax purposes.

Where a long-term loan (granted for a period exceeding 1 year) is made by a non-resident lender, the National Bank of Romania (NBR) must be notified within 30 days of signing of the loan agreement. No such notification is required for short-term loans (granted for periods less than 1 year) unless the loan period is subsequently extended beyond 1 year.

Where it is decided to use debt, a further decision must be made as to which company should borrow and how the acquisition should be structured. To minimize the cost of debt, there must be sufficient taxable profits to offset the interest payments. The following comments assume that the buyer wishes to offset the interest payments against the Romanian target's taxable profits. However, consideration should be given to whether relief would be available at a higher rate in another jurisdiction.

A Romanian company may be used as the acquisition vehicle, funding the purchase with debt either from a related party (i.e. debt pushdown) or directly from a bank. In principle, interest paid can be deductible for corporate tax purposes in Romania (see 'Deductibility of interest').

Deductibility of interest

The interest-deductibility rules that were in force until tax year 2017 (i.e. interest limitation cap and debt-to-equity ratio) have been replaced. As of 1 January 2018, any excess borrowing costs (calculated as the difference between any debt-related costs — including capitalized interest — and income from interest and other economically equivalent income) incurred in a fiscal period that exceed the deductible threshold of EUR200,000 are deductible for corporate income tax purposes up to the limit of 10 percent of 'tax earnings before interest, taxes, depreciation and amortization' (EBITDA). The excess borrowing costs that are treated as non-deductible in a particular year can be carried forward indefinitely. The limitation also applies to any debt-related costs connected to loans from financial institutions. The tax EBITDA is determined as the gross accounting profit, minus non-taxable revenues, plus excess borrowing costs, plus deductible tax depreciation. If tax EBITDA is zero or negative, the excess borrowing costs are not tax-deductible during the current tax period but can be carried forward indefinitely.

These interest-deductibility rules also apply to financial institutions but not to independent entities (entities that are not part of a consolidated group for financial accounting purposes and do not have related parties and permanent establishments), which can fully deduct excess borrowing costs.

The new rules also apply to interest and foreign exchange losses carried forward and accumulated as of 31 December 2017. Some changes to these rules are expected to be adopted during 2018.

Checklist for debt funding

— The use of bank debt may avoid transfer pricing problems.

— 16 percent WHT applies to interest payments to non-Romanian entities unless a lower rate applies under a relevant tax treaty or EU directive.

Equity

A buyer may use equity to fund its acquisition, possibly by issuing shares to the seller in satisfaction of the consideration or by raising funds through a seller placing. Further, the buyer may wish to capitalize the target post-acquisition.

Generally, no capital duty or stamp duty tax is applicable to issues of new shares. Domestic law applies a 5 percent WHT tax on dividends paid by a Romanian company, but lower rates might apply under a relevant tax treaty or EU directive.

Although equity offers less flexibility should the parent subsequently wish to recover the funds it has injected, equity may be more appropriate than debt in certain circumstances. For example, where the target is loss-making, it may not be possible to obtain immediate tax-deductibility for interest expenses.

There may be non-tax grounds for preferring equity. For example, in certain circumstances, it may be desirable for a company to have a low debt-to-equity ratio.

For mergers and demergers, the following tax rules apply:

— By virtue of the EU Merger Directive, which has been incorporated in Romanian law, mergers and demergers are generally tax-neutral; in other words, the transfer of assets from one company to another company in a merger or demerger is not a taxable transfer. Likewise, the transfer of previously untaxed reserves (reserves created from gross profit) is not taxable, provided the reserve is booked in the same account in the absorbing company.

— Assets transferred from one company to another company in a merger or demerger are recognized for tax purposes (including future tax depreciation purposes) at their tax base value on the transferring company's books.

— The right to carry forward interest expenses and net foreign exchange losses for taxpayers that cease operations due to a merger or demerger transaction may be transferred to newly established taxpayers, or to those that take over the assets and liabilities of the absorbed or divided company, as appropriate, proportionally with the assets, equity and liabilities transferred to the beneficiary legal entities, as provided in the merger/demerger plan.

— For taxpayers that do not cease operations as a result of a merger or demerger transaction, the right to carry forward interest expenses and net foreign exchange losses must be divided between them and the taxpayers that partially take over the assets and liabilities of the transferor, proportionally to the transferred assets, equity and liabilities, according to the demerger plan.

— Under an anti-avoidance rule, tax neutrality may not be achieved in cases where tax avoidance is the principal objective for the merger/demerger.

Contributions in kind are not taxable for the person making the contributions, provided that they are part of a transfer of a going concern. Otherwise, such operations are taxable transfers for corporate tax purposes, falling within the scope of the general VAT rules.

Where a company receives an asset from another company via a contribution in kind, the asset is recognized for tax purposes (including future tax depreciation purposes) at its tax base value on the transferring company's books before the contribution.

Where a company contributes an asset to another company via a contribution in kind, the tax base value of the shares received in the second company is assumed to be the same as the tax base value of the assets contributed.

Hybrids

In practice, Romanian companies tend to issue ordinary share capital. More complex equity structures are unusual.

No Romanian law specifically applies to hybrid instruments, but debt may be re-characterized as equity, or vice versa, according to general anti-avoidance rules based on the principle of substance-over-form; that is, the tax authorities may disregard a transaction that does not have an economic purpose or may re-characterize the form of a transaction to reflect its economic substance.

Other considerations

Concerns of the seller

Sale of assets

— The sale of assets may create a taxable capital gain for the seller.

— Capital gains realized by corporate entities are deemed to be corporate profits and are taxed at 16 percent. Transfer taxes (about 1 percent of the value) are also applicable where the transaction involves real estate.

— Capital gains realized by individuals from transfers of real estate are subject to lower tax rates, depending on the value of the transaction.

— Where all assets have been allocated to a specific line of business (which technically is a standalone unit capable of carrying out separate economic activities), the transaction could be viewed as a transfer of a going concern, so it may fall outside the scope of VAT.

Sale of shares

— Any capital gain arising on the disposal of shares is subject to tax for the outgoing shareholders (individuals or companies).

— Where the seller of the shares is an individual, the tax rate applicable to the realized gain is 10 percent of the gain earned on a disposal of shares, whether or not the companies are listed.

— Capital gains obtained by companies from the sale of shares in Romanian companies are non-taxable, provided that certain conditions are fulfilled (e.g. minimum 10 percent shareholding, minimum 1 year holding period).

— Non-Romanian sellers may be entitled to claim Romanian tax exemption under a tax treaty (subject to the treaty's conditions).

Company law and accounting

The Company Law (Law 31/1990) prescribes how Romanian companies may be formed, operated, reorganized and dissolved.

Under this law, the term merger includes both acquisitions (*fuziune prin absorbtie*) and mergers (*fuziune prin contopire*). As such, a merger may be carried out as an absorption of the assets and liabilities of one or more companies by another company or as a transfer of the assets and liabilities of two or more existing companies to a newly formed company. A demerger involves the division of a company into two or more companies (whether existing and/or newly formed).

Group relief/consolidation

There are no corporate tax consolidation rules in Romania. It is not possible for the losses of one company to be offset against the profits of another group company or for companies in a group to offset the tax liabilities of one group company against the tax receivables of another group company. Each member of the group is treated as a separate entity.

VAT position consolidation is permitted in Romania (under specific conditions).

Transfer pricing

Romanian corporate tax law contains transfer pricing rules closely resembling the international principles of the Organisation for Economic Co-operation and Development (OECD). Adjustments to the tax base are possible based on the arm's length principle (but they are unlikely for domestic transactions).

The Romanian Fiscal Procedure Code requires taxpayers who carry out transactions with related parties to prepare a transfer pricing file with proper documentation and present it to the fiscal authorities on request. The file's purpose is to illustrate how the transfer prices used by the taxpayer in transactions with related persons were set and demonstrate that the prices were set following the arm's length principle.

Companies are considered as 'related parties' under Romanian legislation where there is a minimum 25 percent direct or indirect shareholding and/or economic control.

Taxpayers who carry out transactions with related parties may approach the tax authorities for an advance pricing agreement (APA). An APA is an agreement between a taxpayer and the tax administration for a fixed number of years that specifies the methods for determining transfer prices for future transactions between related enterprises. The fee for granting the APA ranges from EUR10,000 to 20,000. The fee for amending a completed APA ranges from EUR6,000 to 15,000. To date, APAs have been uncommon in practice.

Comparison of asset and share purchases

Advantages of asset purchases

— Generally, no previous liabilities are inherited.

— More flexibility in funding.

— Possible to acquire a part of the business.

— Step-up in taxable base of assets.

Disadvantages of asset purchases

— Need to re-negotiate supply, employment and technology contracts.

— Unattractive to seller, so buyer likely to pay premium.

Advantage of share purchases

— More likely to be attractive to seller, so the price may be lower.

— May gain benefit of existing supply or technology contracts.

— May be simpler and involve lower transaction-related fees.

Disadvantage of share purchases

— Liable for any claims or previous liabilities of the entity.

— No step-up in taxable base of assets.

KPMG in Romania

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Russia

Introduction

Mergers and acquisitions (M&A) have become increasingly common in Russia in recent years. A number of legal and tax issues should be considered when such transactions are planned. This report summarizes the applicable provisions in Russian legislation. M&A issues are complex, so every transaction should be planned taking into consideration all the facts and circumstances.

Recent developments

The following summary of Russian tax considerations is based on current tax legislation as of 1 January 2018.

Anti-offshore tax policy

As of 1 January 2015, the following amendments to the Russian tax legislation came into effect as part of the Russian De-offshorization Law:

— controlled foreign company (CFC) rules

— definition of 'tax residency' based on place of effective management

— definition of a 'beneficial owner for tax treaty purposes

— disclosure of information about beneficiaries of companies.

Where a Russian group has companies registered in foreign jurisdictions with favorable tax regimes that are directly or indirectly controlled by a Russian tax resident (company or individual), any accumulated retained profits of these companies could be subject to profits tax in Russia at a rate of 20 percent or personal income tax at 13 percent.

As of 1 January 2018, a 'controlling person' for Russian tax purposes is a Russian tax resident (company or individual) that owns directly or indirectly more than 25 percent of the CFC's capital (or more than 10 percent if the equity interests of all persons who are Russian tax residents exceed 50 percent).

The profits of a legal entity or structure that would otherwise be treated as a CFC are exempt where:

— the CFC is a non-profit organization that does not distribute profits in accordance with the local legislation under which the organization was founded

— the CFC is a tax resident of a country that has concluded a tax treaty with Russia and that exchanges tax information, provided that:

  — the effective tax rate (taking into account withholding tax — WHT) is not less than 75 percent of the weighted average Russian profits tax rate, or

  — the portion of the CFC's passive income is not more than 20 percent of all income.

— the foreign organization is a member state of the Eurasian Economic Union, an operator of a coastal shelf project or a participant in PSA projects, or in certain other cases.

On 12 May 2016, at the Organisation for Economic Cooperation and Development's (OECD) Forum on Tax Administration, Russia signed the Multilateral Competent Authority Agreement on the Automatic Exchange of Financial Account Information, thereby joining the OECD's Standard for Automatic Exchange of Financial Account Information (Common Reporting Standard — CRS).

Joining the CRS will enable the Russian tax authorities to obtain information on financial accounts held by Russian tax-resident individuals and legal entities abroad from the tax authorities of other participating countries. The Russian tax authorities also will be obliged to provide similar information to the tax authorities of partner jurisdictions regarding financial accounts held by tax residents of those jurisdictions with Russian financial institutions. The first exchange of information with partner jurisdictions will occur in 2018.

In June 2017, Russia signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (BEPS). Russia chose to supplement the principle purpose test with a simplified limitation on benefits test.

Concept of 'unjustified tax benefit'

In July 2017, the Russian tax code was amended to include the concept of 'unjustified tax benefit' (introduced in 2006 by the Supreme Arbitration Court). Under these amendments, expenses can be deducted and taxes can be refunded where:

— the company has recorded the transaction for accounting and tax accounting purposes in accordance with its substance

— the main purpose of the transaction is not the underpayment or recovery of taxes

— the contractual obligation was actually performed by the party to the contract concluded with the taxpayer and (or) a person to whom the obligation to perform the transaction (operation) was transferred by another contract or bylaw.

Jurisprudence on deductibility of exchange losses and interest

The tax authorities began treating loans from related parties as capital investments where:

— interest on the loans was accrued but not actually paid

— the debt was not even partially settled by the debtor during the period of the loan maturity

— the loan maturity period was unreasonably extended.

As a result, the tax authorities tend to disallow the deduction of interest expenses and currency exchange losses on such loans. In 2016 and 2017, the Russian courts supported the tax authorities' approach.

Thin capitalization rules

As of 2017, Russia's thin capitalization rules were significantly changed — see 'Deductibility of interest' later in this report.

Tax attributes

In another major change, as of 2017, tax losses accumulated since 2007 can be carried forward indefinitely. However, from 1 January 2017 to 31 December 2020, a taxpayer is entitled to reduce its taxable income for the current tax period by up to 50 percent of tax losses incurred in earlier years.

Asset purchase or share purchase

An acquisition in Russia can be structured as an asset or share deal. The main difference is that, in a share deal, all rights and obligations of the target company (including all historical tax liabilities) remain in the company acquired by the buyer, whereas in an asset deal, historical liabilities remain in the selling entity, with certain exceptions.

A share deal could be performed by acquiring shares in Russian joint stock company (AO) or by acquiring the so-called 'participations' in Russian limited liability companies (OOO). Share deals can also be affected by acquiring shares in the foreign holding companies of Russian targets.

An asset deal is usually a purchase of certain assets of the target company. Tax risks of the target company could transfer to the buyer of assets. Alternatively, the deal could involve the purchase of an enterprise as a property complex, where all the assets and liabilities are assumed as well. This procedure is more complicated and rare in practice (in many cases, the purchase of an enterprise as a property complex occurs when a bankrupt company sells its business).

Note that where parties sign a sale and purchase contract of all the target's assets, there is a risk that the deal could be re-classified as a purchase of an enterprise as a property complex (as has happened). This would cause the liabilities as well as assets to be transferred. In this case, the Russian tax authorities could claim that the buyer has inherited the historical tax liabilities.

KPMG in Russia notes that Russian court practice on asset deals is evolving. Historically, assets deals were generally used to mitigate historic tax risks of the acquired targets. Developing court practice indicates that where the target and the new company to which the target's business was transferred are related, the new company should be liable for the historic tax liabilities of the target.

An asset deal is generally subject to valued added tax (VAT), which could be recoverable for the buyer and profits tax, whereas a share deal, if performed in Russia, is only subject to profits tax.

The implications of both types of purchase are summarized at the end of this report.

Purchase of assets

Assets of a Russian business may be acquired by a foreign legal entity directly or through a Russian branch. The acquired assets may also be contributed to the charter capital of a Russian subsidiary of the buyer. Contributions in kind to the charter capital of joint stock companies must be valued by independent appraisers, unless otherwise stipulated by law. Contributions in kind to the charter capital of limited liability companies must also be valued by independent appraisers. Alternatively, a special-purpose vehicle may be set up in Russia to acquire the assets of the target company.

Purchase price

Generally, the purchase price is determined by the mutual consent of the parties (under the so-called 'freedom of contract' concept). However, the tax authorities could challenge the applied prices using the transfer pricing rules applicable to an asset deal.

Goodwill

Goodwill could arise in a purchase of an enterprise as a property complex. 'Goodwill' is defined as the difference between the purchase price of an enterprise as a property complex and the net book value of its assets. Where the purchase price is higher, the positive difference (positive goodwill) could be deducted for profits tax purposes over 5 years from the month following the month of the state registration of the property complex transfer.

For statutory accounting purposes, goodwill is subject to impairment over 20 years or until the company's dissolution, whichever is sooner.

Where the purchase price is lower than the value of assets, the negative difference (negative goodwill) is subject to profits

tax in the month of the state registration of the property complex transfer.

The seller can deduct a loss on the sale of an enterprise as a property complex for profits tax purposes.

Depreciation

Depreciation of assets is generally deductible for profits tax purposes in Russia. Depreciation rates depend on the assets' useful life.

The useful life of an asset is determined at the date when the fixed asset is put into operation, based on the classification of fixed assets included in prescribed depreciation groups. Where a particular fixed asset is not included in the classification, the taxpayer should determine the fixed asset's useful life, taking into account the technical characteristics of the asset and recommendations of the manufacturer.

According to Russian tax legislation, a taxpayer is entitled to apply either a straight-line or a reducing-balance method of depreciation.

A depreciation premium of 10 to 30 percent of the acquisition cost of fixed assets is available as an immediate deduction when the fixed assets are commissioned.

Tax attributes

Tax losses of the target company are not transferred to the buyer under an asset deal. The buyer inherits customs risks of the assets of the target company in an asset deal. Tax liabilities of the target company could transfer to the buyer of assets in an asset deal, where the deal had no business rationale and was aimed at tax avoidance.

Value added tax

The sale of most assets is subject to 18 percent VAT. Where a foreign legal entity acquires an asset directly and wishes to transfer the acquired asset to its business in Russia (e.g. contribute the asset to the charter capital of its subsidiary in Russia) and where the foreign legal entity is not tax-registered in Russia, the amount of the input VAT paid on the acquisition is a cost to the investor. Where the asset is acquired by an investor's Russian subsidiary, the input VAT on the acquired asset may be offset against the subsidiary's output VAT.

The contribution of an asset to the charter capital of a Russian company is not subject to Russian VAT. However, the Russian subsidiary contributing the asset to the charter capital should reinstate previously offset VAT (for fixed assets, at their net book value). Reinstated VAT should be shown separately in the transfer documents and can be offset against output VAT of the company that received the contribution in kind.

The sale of an enterprise as a property complex is subject to specific VAT rules. For example, the tax basis should be defined as the net book value of assets per statutory accounting multiplied by a special ratio (where the purchase price differs from the net book value of the assets sold).

Where the purchase price is lower than the net book value of assets, the correcting ratio is determined by the proportion the purchase price is of the net book value. Where the purchase price exceeds the net book value, the correcting ratio is calculated in the same way but the numerator and denominator of the proportion are reduced by the value of accounts receivables and the value of securities (if no decision about their revaluation has been made).

The seller must provide the buyer with an inventory report and a consolidated invoice grouped by type of asset.

The sale of assets and property rights of a bankrupt company is not subject to VAT. Therefore, the buyers of such property or property rights have no obligation to act as a tax agent.

Property tax

Generally, property tax is levied at a maximum rate of 2.2 percent (set by the regional authorities) of the average net book value of the taxpayer's fixed assets. The net book value of fixed assets is determined based on statutory financial statements.

Starting from 2018 regional authorities can provide the property tax exemption for movable property recorded in the taxpayer's financial accounting on or after 1 January 2013 except for:

— property received in the process of reorganization or liquidation of a legal entity

— property received from the related parties and classified in a depreciation group other than the first and second depreciation groups.

If regional authorities did not determine property tax exemptions for movable property by 1 January 2018, the exemption would not apply from that date. However, for 2018, the maximum rate is 1.1 percent rate.

The property tax base for the following immovable properties is determined based on their cadastral value:

— administrative, business and shopping centers and premises situated in them

— non-residential premises to be used or intended to be used for offices, commercial facilities, catering and domestic services

— any immovable property owned by foreign companies that do not carry out business activity through a permanent establishment (PE) in Russia

— immovable property owned by foreign companies that does not relate to business activity carried out through the PE by the foreign company.

The tax rate for these items is 2 percent.

Purchase of shares

Generally, a share deal may be preferable for the seller where the seller is a foreign legal entity since, according to Russian

tax legislation, capital gains from the sale of shares are tax-exempt unless more than 50 percent of the assets of a target company directly or indirectly consist of immovable property located in Russia.

Tax indemnities and warranties

In a share acquisition, the buyer takes over the target company together with all its assets and liabilities, including contingent liabilities. Therefore, the buyer normally requires more extensive indemnities and warranties than in the case of an asset acquisition. In order to protect itself from potential tax risks, the buyer may wish to initiate a due diligence procedure and include some indemnities in the sale-purchase agreement.

Tax losses

Tax losses accumulated since 2007 can be carried forward indefinitely. The taxpayer is entitled to reduce its taxable profits by the previously incurred losses, provided that during the whole period of their use, the taxpayer retains the supporting documents that prove the losses were incurred. From 1 January 2017 to 31 December 2020, a taxpayer is entitled to reduce its taxable profit for the current tax (reporting) period by tax losses incurred in prior years by not more than 50 percent of the taxable profit of the current period.

In a reorganization, a company that takes over all the rights and obligations of the reorganized company is entitled to reduce its taxable profit by the amount of losses incurred by the reorganized company before its reorganization.

Crystallization of tax charges

As the buyer of shares takes over the target company together with all its liabilities, the buyer inherits all the target's historical tax risks. Therefore, the buyer usually obtains an appropriate indemnity from the seller regarding outstanding historical tax liabilities. The buyer may ask the target company to obtain a reconciliation statement and a statement of personal account from the tax authorities at the latest possible date preceding the date of a share deal. However, where the target company has no outstanding tax obligations according to these documents, the possibility remains that the tax authorities may challenge the accuracy and timeliness of the tax calculations and payments and accrue additional taxes and penalties in the future.

It is also advisable to consider carefully the results of the field tax audits of the target company. Generally, 3 calendar years preceding the current year are subject to field audit by the tax authorities. However, in certain cases, the closed tax periods) may be subject to repeat tax audits. Among other things, such a repeat audit could be performed where:

— the taxpayer is regarded as inhibiting the exercise of the tax control by the tax authorities

— the higher tax authorities are checking work done by the lower tax authorities

— a criminal case is brought against the officers of the company on the grounds of tax evasion.

Transfer taxes

Stamp duty is not applied in Russia, but similar duties are charged at nominal amounts.

Tax clearances

Taxpayers can obtain tax clarifications from the tax authorities on unclear or questionable provisions in Russian tax legislation. If the taxpayer follows such clarifications and the tax authorities then challenge the case, the taxpayer is exempt from penalties (fine and late payment interest) but not the tax itself. However, the authorities may claim that their clarifications were based on insufficient or uncertain information provided by the taxpayer. In this case, the taxpayer is not exempt from paying penalties.

As of 2016, taxpayers have the option of obtaining tax rulings on their planned transactions. The tax ruling tool is available only to major corporate taxpayers that apply the tax monitoring regime, which provides access to the tax authorities to accounting and tax accounting, as well as to source documents of organizations. Taxpayers subject to tax monitoring can apply for a tax ruling from the tax authorities on the tax treatment of certain transactions not explicitly addressed in the current legislation. Such rulings are binding, and taxpayers are required to follow the treatment recommended by the tax authorities.

Choice of acquisition vehicle

Several possible acquisition vehicles are available to a foreign investor, and tax consequences often influence the choice.

Local holding company

Where the buyer uses debt financing to acquire a Russian target, it may be reasonable to set up a Russian holding company as an intermediary. Under Russian tax legislation, interest expenses are deductible for profits tax purposes irrespective of whether a loan was taken out for investment or current business needs. There are certain limitations on interest deductibility (see 'Deductibility of interest').

A post-acquisition merger of the intermediate holding company and the target company could be considered. This would make it possible to offset the holding company's interest expenses against the target company's income (the holding company would not have such income). Maintaining one company instead of two also would reduce administrative costs. However, such a cascading structure is inefficient for dividend payments. Dividends are subject to tax at a rate of 0 percent where certain conditions are met or at 13 percent when distributed to the holding company. This tax may not be creditable against further taxation of dividends paid to the foreign shareholder.

Where the merger is mainly motivated by tax considerations, the tax authorities could invoke the concept of 'unjustified tax benefit' and assess additional taxes as if no merger had occurred. Currently the court practice is developing in this respect and Russian tax authorities pay close attention to the matters of economic justification and business purpose of financial transactions, and their context and all the attendant circumstances.

Under the 'beneficial ownership' concept, the Russian tax authorities may challenge the application of the rates for Russian tax residents and apply the rate of 15 percent on dividends unless the reduced WHT rates could be applied.

Foreign parent company

A foreign buyer may wish to acquire the shares of a Russian company without an intermediary, which should be considered where the foreign parent plans to resell the target. Russia does not tax capital gains on shares sold by a foreign legal entity unless more than 50 percent of the assets of the Russian target directly or indirectly consist of immovable property located in Russia.

Although Russia levies WHT on dividends, interest and royalties paid to a foreign entity, the WHT can be reduced or eliminated by an applicable tax treaty subject to ownership test. Russia has an extensive network of such treaties.

A foreign investor may acquire shares in a Russian company for cash or in exchange for contributions in kind of property (assets or shares). In this case, the tax basis of the acquired shares in the Russian company is equal to the tax basis of property (shares) given in exchange for the shares and costs related to the contribution.

The tax basis of property (assets or shares) received by the Russian company also is equal to the tax basis of the contributed property stated in the records of the investor on the date of transfer (but not higher than the market value of the transferred property, as confirmed by an independent appraiser for transfers made by a foreign investor). Where the Russian company lacks supporting documents for the cost of property received, the tax basis of property is zero for Russian profits tax purposes.

PE issues should also be taken into account. According to the Russian Tax Code, the activities of a foreign legal entity may create a PE in Russia where the foreign entity has a place of business in Russia (i.e. branch, office, bureau or other separate division) and regularly engages in business activities through this place (unless the activities are preparatory or auxiliary in character). Most tax treaties between Russia and other countries set similar criteria for determining whether a PE of a foreign legal entity (FLE) exists in Russia.

In response to growing demand from market players, the M&A Tax practice of KPMG in Russia is developing various structures, such as a 'transparent' joint venture, which that would not be considered as a beneficial owner of income by the Russian tax authorities within the process of dividend or disposal income distribution. Such arrangements would allow beneficial ownership to shift to the upper level, so that further dividend or share disposal flows between that sub-holding (i.e. tax-transparent joint venture), so that factual recipients of income could be taxed at preferential tax treaty rates.

Non-resident intermediate holding company

A non-resident intermediate holding company could be used to reduce WHT on dividends, interest and royalties by applying a favorable tax treaty with Russia. However, the Russian tax authorities may challenge the application of a tax treaty if they consider that the holding company is a conduit company established to obtain a tax benefit (so-called 'unjustified tax benefit' concept).

PE issues should also be taken into account.

Local branch

Instead of directly acquiring the target company, a foreign buyer may structure the acquisition through its Russian branch. The taxation of a branch depends on whether it constitutes a PE in Russia. An FLE's acquisition of shares or participation units of a Russian legal entity is not deemed to create a PE in Russia unless other characteristics of a PE are present.

Where the branch does not constitute a PE in Russia, the tax consequences on the subsequent sale of the target are the same as where a foreign parent company is used as an acquisition vehicle: there is no capital gains tax on shares sold by an FLE unless more than 50 percent of the assets of the target directly or non-directly consists of immovable property located in Russia.

Where the branch constitutes a PE in Russia, capital gains are taxed in the same way as capital gains of the Russian company (20 percent profits tax).

Joint venture

A joint venture may be corporate (usually in the form of an OOO) or not corporate (joint venture agreement). A corporate joint venture is considered a Russian legal entity and normally is subject to the general tax regime.

Where a joint venture is to be set up as a simple partnership, certain conditions must be met. For example:

— Participants in a joint venture must carry out separate accounting of joint venture operations and operations not related to the joint venture activities.

— If one of the participants is a Russian legal entity, it should carry out the tax accounting of a joint venture.

— Only a Russian participant is entitled to recover input VAT.

Choice of acquisition funding

Typically, acquisitions are financed with debt, contributions to equity or hybrid instruments. The main tax issues arising for these alternatives are summarized below.

Debt

Debt financing may be preferable from the tax viewpoint because the buyer can deduct interest expenses for profits tax purposes (subject to certain limitations). Payment of dividends, by contrast, does not give rise to a tax deduction. However, before using debt financing, the company should thoroughly consider certain financial factors and determine whether it is better to borrow from a bank or from another legal entity, related or unrelated.

Deductibility of interest

Generally, interest on debt instruments is deductible for profits tax purposes regardless of whether the loan is taken out for investment purposes or current business needs.

Interest expenses accrued on loans under controlled transactions for the purposes of Russian transfer pricing rules is fully deductible for profits tax purposes if the interest rate is in the range determined by the Russian Tax Code. Otherwise, the limitation under the Russian transfer pricing rules would apply.

Interest rates for loans received under controlled transactions (regardless to the amount and term of loan) should not exceed:

— for loans denominated in Russian rubles (RUB): 180 percent (for periods starting in 2015) or 125 percent (for periods starting in 2016 or later) of a key rate of the Central Bank of Russia (CBR)

— for loans nominated in euros (EUR): Euro Interbank Offered Rate (EURIBOR) plus 7 percent

— for loans nominated in Chinese yuan: Shanghai Interbank Offered Rate (SHIBOR) plus 7 percent

— for loans issued in British pounds: London Interbank Offered Rate (LIBOR) plus 7 percent

— for loans issued in Swiss francs or Japanese yen: LIBOR in appropriate currency plus 5 percent

— for loans issued in other currencies: LIBOR in US dollars (US$) plus 7 percent.

The key interest rates of CBR, LIBOR, EURIBOR and SHIBOR should be determined:

— as at the date of receipt of the loan principal at the borrower's bank account if fixed interest rate is provided by the loan agreement, or

— as at the date of recognition of interest income (i.e. end of each month) for other loan agreements.

The applicable borrowing period of LIBOR, EURIBOR and SHIBOR rates should be determined similar to the term of loan agreement.

Firstly, the thin capitalization rule applies where

— a Russian borrower receives a loan from a related foreign company or an individual that directly or indirectly owns more than a 25 percent share in the Russian borrower, or

— indirectly owns the Russian borrower through a chain of shareholdings in which each preceding person directly owns more than 50 percent of the shareholding in each subsequent company.

Secondly, the thin capitalization rule applies here a Russian borrower receives a loan from a Russian or foreign person that is treated as related to a foreign company meeting the above criteria if the Russian borrower is:

— a company that directly or indirectly owns more than a 25 percent share in the foreign company or vice versa

— an individual who directly or indirectly owns of more than a 25 percent share in the foreign company

— a company more than 25 percent of which directly or indirectly belongs to the same person that directly or indirectly owns more than a 25 percent share in the related foreign company

— a person that indirectly holds the foreign company through a chain of holdings in which each preceding person directly owns more than a 50 percent share in each subsequent company and vice versa.

Thirdly, the thin capitalization rule applies to a Russian borrower that receives a loan from any Russian or foreign third party (e.g. bank) and the loan is guaranteed by a related foreign person and/or by a related Russian person

Loans in the second and third instance above are not treated as controlled debt if certain criteria are met and the lender provides written confirmation as to its compliance with these criteria to the Russian borrower.

Interest paid on controlled debt that exceeds the 3:1 ratio (12.5:1 for companies that perform only leasing activity) is non-deductible and is treated as a dividend that is subject to Russian profits tax withholding when paid.

Exchange losses on loans are fully deductible, and gains are fully taxable. However, the Russian tax authorities may seek to challenge negative exchange losses on interest on the basis of the limitations in the thin capitalization rules or treat the loan as capital investment rather than debt financing.

Withholding tax on debt and methods to reduce or eliminate it

The statutory WHT rate on interest income is 20 percent, whereas the majority of tax treaties, which override domestic

law, provide for 0 or 5 percent rates. To obtain treaty relief, the foreign company receiving the interest income should be a beneficial owner and provide the Russian company and its tax agent with:

— a tax-residency certificate, and

— documents confirming the beneficial ownership to the passive income being paid from Russia.

Checklist for debt funding

— The use of a bank loan could help the buyer eliminate or mitigate thin capitalization and transfer pricing problems.

— The 20 percent statutory WHT rate on interest income may be reduced by applying the provisions of a tax treaty that provides for a lower rate.

Equity

According to Russian law, the contribution of cash by a shareholder (parent company) to the share capital of a Russian company (target company) is not a taxable event, but dividends paid to a parent company are subject to WHT. Where a parent company is a Russian legal entity, dividends paid are subject to WHT at a general rate of 13 percent (0 percent if certain conditions are met). Dividends paid to a foreign parent company are subject to WHT of 15 percent, unless reduced by treaty (WHT can be reduced to 5 percent under some treaties).

Forms of reorganization

Generally, the reorganization of a legal entity is tax-neutral. Neither the reorganized company nor the new company created by the reorganization should be subject to any additional taxation.

According to Russian civil law, the reorganization of a legal entity can take one of five different forms: merger, takeover, split-off, spin-off and conversion.

The Russian Tax Code stipulates that obligations to pay taxes and fees of a reorganized legal entity should be fulfilled by its legal successor(s):

— On a merger of several legal entities, the legal entity resulting from the merger should be recognized as the successor regarding the obligation to pay taxes and fees of each of the original legal entities.

— On a takeover of one legal entity by another legal entity, the accessing legal entity should be recognized as the successor to the obligations to pay taxes and fees of the accessed legal entity.

— On a split-off of a legal entity into several legal entities, the legal entities resulting from the division should be recognized as successors regarding the obligations to pay taxes and fees of the original organization.

— On a spin-off from a legal entity, no succession to the reorganized legal entity regarding its obligations to pay taxes should arise. Where the reorganized legal entity cannot fulfill its obligations to pay taxes and fees in full due to the separation from a legal entity by one or more legal entities, then, pursuant to a court decision, the separated legal entities may be obligated jointly and severally to pay the taxes and fees of such legal entity.

— On a conversion of one legal entity into a new one, the legal entity resulting from the conversion should be recognized as the successor to the obligations to pay taxes and fees of the reorganized legal entity.

Hybrids

Hybrid instruments are classified as debt or equity for tax purposes depending on their legal form, rather than on their economic substance. Thus, in principle, hybrid instruments, such as profit-sharing loans and interest-free loans, are classified as debt for tax purposes. In theory, the tax authorities may claim in arbitration court that such instruments are not debt by asserting that they are fictional instruments that actually disguise the distribution of profits. However, the tax authorities' chances of being successful in court are very low. Note that hybrid instruments are very rare in Russia.

Discounted securities

According to the Russian Tax Code, any previously determined income (including a discount) received from any kind of debenture is interest income and subject to a 20 percent tax WHT.

Deferred settlement

An acquisition often involves an element of deferred consideration, the amount of which can only be determined at a later date on the basis of the business's post-acquisition performance. The Russian Tax Code has no specific provisions on the taxation of such transactions; the tax consequences depend on the wording of relevant supporting documentation and the relationships between the parties. Generally, deferred settlement could be taxed as follows (depending on whether foreign or Russian legal entities are involved):

— For a foreign seller with no PE in Russia, the Russian buyer's obligation to withhold tax arises at the moment of payment. Therefore, deferred settlement payments to foreign companies should be subject to Russian WHT (if any) at the moment of payment.

— The situation where deferred settlement is due to the Russian legal entity is more complicated and depends on the precise contract terms and the tax policy of this Russian legal entity. A tax liability could arise on the receipt or accrual of deferred settlement amounts.

Other considerations

Some of the many other considerations that should be taken into account when structuring M&A transactions are as follows:

— The target's business could be transferred to a new legal entity.

— A simple partnership with joint activities could be formed.

— Many other options and combinations are available, depending on the specifics of the target and the transaction. Non-tax factors, such as company law, anti-monopoly provisions and currency controls, should be considered.

Concerns of the seller

The tax consequences for the seller depend on whether it is a Russian legal entity or an FLE.

A seller that is a Russian legal entity is subject to a 20 percent tax on capital gains, provided its expenses are supported by the required documents. Where there is no documentary evidence of expenses, the gross income from the sale is subject to taxation.

A seller that is an FLE is exempt from tax on capital gains unless more than 50 percent of the assets of the target company consist of immovable property located in Russia (otherwise, capital gains are subject to 20 percent profits tax).

Where the seller is an individual, capital gains are subject to 13 percent income tax for Russian residents and 30 percent for non-residents.

Tax-free sale of shares

As of 1 January 2011, a 0 percent profits tax rate applies to income received from the sale of shares in Russian companies that are not publicly traded (and publicly traded shares in high technology companies) if a taxpayer held the shares for more than 5 years. The tax authorities interpret this provision as applying to shares acquired after 1 January 2011.

Tax rules for reduction of charter capital

As of 1 January 2018, income in the form of property and property rights received by a shareholder on the reduction of charter capital of a subsidiary is exempt from profits tax (provided certain conditions are met).

On the sale of shares and participation interests, capital gains realized should be increased by the amount of previously exempt income.

Company law and accounting

Commercial entities in Russian are consist of companies, partnerships, production cooperatives and state and municipal unitary enterprises. The most widespread are AOs and OOOs.

Joint stock company (AO)

— An AO is a legal entity that can be either public or non-public. The shares of public AO are traded on a stock exchange.

— The minimum share capital for a public AO is RUB100,000; for a non-public AO, it is RUB10,000.

— The minimum number of shareholders (public and non-public) is one (unless the only shareholder is a legal entity owned by one person).

Limited liability company (OOO)

— The minimum charter capital for an OOO is RUB10,000.

— The minimum number of participants is one (unless the only participant is a legal entity owned by one person).

— The maximum number of participants is 50.

— Participants are not liable for the company's debts.

— Shareholders are not liable for the company's debts.

The taxation regime does not depend on the legal form of the company.

Anti-monopoly legislation

Generally, the anti-monopoly law sets certain restrictions on transactions and contractors. A number of transactions require preliminary consent from the responsible authorities or a simple notification after the event.

For example, prior consent is required for:

— a reorganization in the form of a merger of commercial organizations where:

  — the aggregated net book value of their assets at the last reporting date preceding the request to the anti-monopoly authorities exceeds RUB7 billion

  — the aggregated sales turnover for the year preceding the merger exceeds RUB10 billion.

— certain sales of shares (participation units), rights and/or property where:

  — the aggregated net book value of the target and buyer's assets exceeds RUB7 billion

  — the aggregated sales turnover for the year preceding the deal exceeds RUB10 billion and the net book value of the target's assets exceeds RUB400 million.

Group relief/consolidation

The conditions that need to be met to obtain group relief effectively mean that there are few consolidated taxpayers in Russia.

For other Russian legal entities that do not form consolidated tax groups but have branches or representative offices, the profits tax is calculated on a consolidated basis by the head office. Profit is attributed to each branch based on a proportion of the average number of employees of the branch and the residual value of the depreciated fixed assets of the branch.

Tax-grouping

As of 1 January 2012, tax-grouping was introduced in Russia. This regime applies to a group of companies where one company has a direct or indirect participation of not less than 90 percent in the charter capital of each group company. Tax-

grouping is only available where, for the preceding year, the total amount of taxes paid by the applying companies is not less than RUB10 billion, total sales are not less than RUB100 billion, and total assets as at 31 December of the preceding year are not less than RUB300 billion. Tax-grouping is available for profits tax only and should be formalized by an agreement signed by the participating companies. The tax group is formed for a period of not less than 5 profits tax periods (calendar years).

The accumulated tax losses incurred by the taxpayer before the tax grouping agreement is concluded are not deductible against the consolidated profits of the tax group.

Where the taxpayer chooses to exit the tax group, these losses become available for deduction.

Similarly, individual taxpayers cannot utilize part of tax losses incurred by the tax group if they choose to exit the tax group or are no longer eligible for the tax consolidation.

Considering the turnover and assets requirements and the limitations on utilization of accumulated tax losses, KPMG in Russia expects that tax-grouping will remain rare in Russia.

Until 2018, the creation of new consolidated tax groups has been suspended.

Transfer pricing rules

As of 1 January 2012, new transfer pricing rules were introduced in Russia. These rules differ significantly from the previously used formal approach and generally correspond to OECD principles. Under the new rules, the tax authorities should calculate price adjustments:

— based on prices available on comparable transactions having the same or similar financial or commercial conditions, including functions performed, assets employed and risk undertaken by the parties of a transaction

— by applying the most suitable pricing method that, in the facts and circumstances, enables a justified conclusion regarding the level of prices

— based on market price intervals or profitability intervals estimated based on available information regarding transactions between unrelated parties

— as symmetrical adjustments for both parties of the transaction (e.g. if sales revenue of one party of the transaction is increased, cost of sales of the other party should be increased accordingly).

Under the Russian transfer pricing rules, as 1 January 2012, the following transactions are subject to transfer pricing regulation (so-called 'controlled transactions'):

1. cross-border transactions between related parties (any materiality)
2. cross-border transactions with oil and oil products, ferrous and non-ferrous metals, precious metals and precious stones (e.g. goods traded on international stock exchanges) where proceeds from transactions with the same counterparty exceed RUB60 million in 1 calendar year
3. transactions where one of the parties is a tax resident in a country included in the Russian Ministry of Finance's blacklist and where proceeds from transactions with the same counterparty exceed RUB60 million in 1 calendar year
4. transactions between related parties where:
   a. the total proceeds from the transactions exceed RUB1 billion
   b. one party is subject to the mineral extraction tax and the total proceeds from the transactions exceed RUB60 million
   c. one party is subject to the unified tax on imputed income or unified agricultural tax regime while the other party does not apply these tax regimes and the total proceeds from the transactions exceed RUB100 million (as of 2014)
   d. one party applies a 0 percent profits tax (e.g. currently is a resident of the innovation center Skolkovo) while the other party does not apply this tax rate and the total proceeds from the transactions exceed RUB60 million
   e. one party is a resident of a special economic zone in Russia while the other party is not a resident of a special economic zone and the total proceeds from the transactions exceed RUB60 million (as of 2014).

Transactions between members of a consolidated group of taxpayers are not subject to the transfer pricing regulations. The regulations also do not apply to transactions between companies that simultaneously meet the following criteria:

— are registered in the same region of the Russian Federation

— do not have separate divisions in different Russian regions or outside the Russian Federation

— do not pay profits tax in different regions of the Russian Federation

— do not have tax losses

— none of the parties are a payer of the mineral extraction tax and the transactions do not fall under points 4.b–4.e above.

Controlled transactions involve goods, works and/or services. When analyzing the comparability of the commercial and financial terms of these transactions with the terms of uncontrolled transactions, a number of indicators should be taken into account, including:

— characteristics of the goods, services or works

— functions of the parties to the transaction

— terms and conditions of the contracts

— economic environment

— market (commercial) strategies of the parties to the transaction.

Fines are being introduced for violating the transfer pricing law. For example, if taxes are underpaid because of non-arm's length prices, the following fines apply:

— for 2014–2016 — fine of 20 percent of the unpaid taxes

— for 2017 and later years — fine of 40 percent of the unpaid taxes but not less than RUB30,000.

The following methods can be used to determine the range of arm's length prices: comparative uncontrolled price (CUP) method, re-sale price method, cost plus method, comparable profitability method, and profits allocation method.

The CUP method usually is the preferred method. However, for transactions in which goods are purchased and re-sold without any modification, the re-sale price method is the preferred method. Where the preferred method cannot be applied, the method that is most appropriate for the transaction should be applied.

Taxpayers must keep transfer pricing documentation as evidence that the prices used are within the range of arm's length prices and submit information to the tax authorities for all controlled transactions.

For taxpayers who qualify as 'major taxpayers' (as defined in the Russian Tax Code), the new law introduced the possibility of concluding advance pricing agreements (APA) with the tax authorities (i.e. where the taxpayer and the tax authorities agree in advance to apply a specific methodology to calculate the range of arm's length prices). A duty of RUB2 million is payable for the signing of an APA.

With these recent changes, Russian transfer pricing legislation has become more detailed and well developed, which could enable the tax authorities to more successfully defend their positions in court.

Dual residency

Generally, dual residency conflicts are resolved by the relevant tax treaty by means of tax credit or exemption. Since obtaining these usually involves certain bureaucratic and time-consuming procedures, intentional dual residency is usually not used by Russian companies (the Russian residency of which is defined by registration).

Foreign investments of a local target company

Russian legislation limits the activities of non-Russian investors participating in companies that are of strategic value to Russia (so-called 'strategic companies'). These activities include:

— exploration of subsoil and extraction of mineral resources on land plots of national significance

— aerospace activities

— certain services provided by a natural monopoly or a company with a dominant position on the Russian market

— harvesting of live aquatic resources

— activities controlling hydrometeorological and geothermal processes and events

— certain activities related to the use of nuclear and radiation-emitting materials

— certain activities related to the use of encrypting facilities and bugging equipment

— military-technical activities.

Non-Russian investors (i.e. non-Russian private companies, non-Russian individuals and Russian companies controlled by non-Russian companies or individual(s)) are permitted to carry out transactions that would result in their obtaining control over a strategic company. However, such transactions, among others, must be approved by state authorities.

Comparison of asset and share purchases

Advantages of asset purchases

— The price of purchased assets can be depreciated for profits tax purposes.

— If the acquiring company is in a loss position, such losses may be used against profits generated by the acquired business in the case of merger or takeover.

— Possible to acquire only those assets that the buyer really needs (which could be useful, among other things, where the buyer wants to acquire only part of a business).

— Tax liabilities and tax exposures of the target company could remain with the target company and not transfer to the buyer.

— Where the target merges with its shareholder after the sale of its assets, the target's profits of the target accumulated before the transfer of assets are transferred to the shareholder without additional taxation. Under a share purchase, such profits, when distributed, are subject to WHT at 13 (0) or 15 percent, or less in accordance with a tax treaty.

Disadvantages of asset purchases

— The sale of assets is subject to VAT, except for assets and property rights of a bankrupt company, which may result in a negative cash flow impact for the buyer. If the buyer's business is VAT-exempt, the input VAT is capitalized.

- Profits tax could be due if assets with a high market value and low tax basis are sold.
- Accumulated tax losses remain with the seller.
- Losses incurred on the sale of fixed assets are not immediately deductible and are recognized evenly over the period of the remaining useful life of the assets.
- Customs risks cannot be eliminated.
- An asset deal could be reclassified as the sale and purchase of an enterprise as property complex, resulting in inheritance of all liabilities thereof.
- It may not be possible to transfer all assets to another company where, for example, some assets are used as collateral securing loans and borrowings.
- Transfer of licenses might be impossible.
- Assets not reflected in the Russian accounting principles (RAP) balance sheet may not be transferred.
- Difficulties in interrupting a long production cycle or construction in progress for the transfer of assets.
- Difficulties in obtaining consent from minority shareholders for the sale of assets.
- Long registration process of some asset deals.
- Significant VAT and customs duties clawback.

Advantages of share purchases

- Capital gains from the sale of shares could be tax-exempt in certain cases if the deal is properly structured.
- Sale of shares is not subject to VAT.
- Tax losses accumulated by the target prior to acquisition may be used after the changes in shareholding of the target.
- The share acquisition procedure is technically less complicated than an asset deal; however, it may be necessary to perform anti-monopoly procedures.

Disadvantages of share purchases

- All tax liabilities and tax risks of the target are inherited.
- Capital gains received by the seller could be subject to taxation in Russia: 20 percent profits tax payable by a corporate seller or 13 percent personal income tax payable by an individual seller who is a Russian tax-resident.
- Goodwill cannot be depreciated for profits tax purposes; only the net book value of assets can be depreciated.
- Consolidation of profits and losses of the buyer with the profits and losses of the target company is not allowed (except in the case of a post-acquisition merger or takeover).

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Slovakia

Introduction

This overview of the Slovak business environment, structures for mergers and acquisitions (M&A) and related tax issues covers the statutory framework for acquisitions in Slovakia. It does not consider specific contractual arrangements that may affect these acquisitions. This discussion reflects the state of the Slovak legislation and proposed changes as of 1 January 2018.

Asset purchase or share purchase

There is a significant difference between the tax treatment of asset deals and share deals. The key tax aspects of both types of transaction are summarized in this report.

Purchase of assets

Assets can be purchased as individual assets, as a business or as part of a business. In principle, in a pure asset deal, the buyer does not assume the liabilities of the company from which the assets are acquired.

On the sale of a business or part of a business, the seller is obliged to transfer to the buyer all assets, rights and other property related to the operation of the business, and the buyer is required to assume all obligations related to the operation of the business and to pay the purchase price. Thus, the business or a part of a business is transferred as a going concern, but public law obligations (e.g. tax payable) are not transferred with the business or part of a business.

The transfer of the business from the seller to the buyer also includes employment relationships and obligations and industrial property rights.

The Slovak Commercial Code applies the same principles to a sale of part of a business as to the sale of a whole business, but such a part of a business must be categorized as an independent operational unit before the sale. Consequently, the part of the business should maintain its own books and have records of assets and liabilities relating to that part of the business.

Purchase price

The purchase price of assets generally is considered as the acquisition value for tax depreciation purposes. Generally, the acquired assets may be depreciated for tax purposes (up to the acquisition price), except for certain items listed in the tax law, such as land. For the seller, a tax loss on certain assets sold is not considered as tax-deductible (e.g. loss on the sale of land).

When acquiring a business or part of a business, it is essential for the sale-purchase agreement to stipulate the acquisition price for each individual asset. This helps avoid problems in determining the acquisition price for the respective assets acquired with the business.

Goodwill

Goodwill, positive or negative, does not arise in the purchase of individual assets but may arise in the purchase of a business or part of a business. As of 1 January 2010, the assets acquired on the sale or purchase of a business or part of a business should be valued for tax purposes at their fair values according to accounting regulations. Depreciation of goodwill or release of negative goodwill should be included in the tax base, as a cost or income respectively, over a maximum of 7 tax periods, starting with the period in which the goodwill arose (i.e. in the year of the purchase of business) at one-seventh of the value each year. This treatment is subject to specific conditions, such as a business continuity test.

Depreciation

The tax depreciation does not have to be the same as the accounting depreciation of assets, except for the depreciation of intangible and low-value assets, which follows the accounting rules.

Tax attributes

Assets are depreciated in six tax depreciation groups over periods of 4, 6, 8, 12, 20 or 40 years. To a limited extent, it is possible to split an asset into its component parts and depreciate them separately. Tax depreciation of tangible assets may be interrupted for any period.

There are two basic tax depreciation methods: the straight-line method and the accelerated method. The accelerated method of tax depreciation is allowed only for groups 2 and 3 of the tangible assets (i.e. useful life 6 or 8 years).

Value added tax

Valued added tax (VAT) is levied at the rate of 20 percent on most goods and services (a reduced 10 percent rate is levied on certain medical products, pharmaceuticals, some basic food products and books). A taxpayer who has acquired individual assets can usually claim back the VAT paid on their acquisition if the assets are used to produce taxable supplies (subject to exceptions specified by the law).

A legal entity or individual who has acquired a business or part of a business from a Slovak VAT-registered entity becomes a Slovak VAT-registered taxpayer automatically from the date on which the business or its part is acquired. The successor company of a VAT-registered company that is wound up without liquidation also becomes a VAT-registered taxpayer automatically from the date on which it becomes the legal successor. A taxable person selling a building, its part or building land in an amount exceeding 49,790 euros (EUR) becomes a VAT-registered taxpayer unless the sale is exempt from VAT in line with the Slovak VAT Act. These taxpayers are required to notify the tax authorities of the event that made them VAT-registered taxpayers within 10 days.

Transfer taxes

Under Slovak tax legislation, a purchase of assets is not subject to a stamp duty. Foreign investors are only obliged to pay administrative fees related to the purchase.

Purchase of shares

Generally, under Slovak income tax legislation, capital gains on a sale of shares in a Slovak company are considered to be liable to Slovak corporate or individual income tax.

For individuals, an income tax rate of 19 percent applies to their tax base not exceeding EUR35,268.06 (for 2018); a rate of 25 percent applies to the portion of the tax base in excess of EUR35,268.06. Certain income from sale of shares by individuals qualifies for a tax exemption. For companies, a corporate income tax rate of 21 percent applies.

Where a Slovak company sells shares, it is always liable to tax in Slovakia on the transaction. Generally, a loss from the sale of shares is not deductible.

As of 1 January 2014, income from the sale of shares in a Slovak company generated by a Slovak tax non-resident is treated as Slovakia source income under Slovak rules unless the seller is a tax resident of the European Union (EU). If real estate forms more than 50 percent of the equity of the Slovak company, the capital gain from the sale of shares in the Slovak company is always subject to tax in Slovakia, unless an applicable tax treaty provides otherwise. In addition, where the buyer of the shares is a Slovak tax resident or Slovak permanent establishment (PE) of a non-resident, income from the sale of shares is taxable in Slovakia even in the case of EU residents. Exemption from tax on capital gains may again be available under a tax treaty.

Tax indemnities and warranties

In a share acquisition, the buyer takes over the target company together with all related liabilities, including contingent liabilities. In this case, the buyer may require more extensive indemnities and warranties than in the case of an asset acquisition. From a tax perspective, it is advisable to seek tax warranties and indemnities covering a period of at least 6 years after the end of the year in which the share-purchase agreement (SPA) was signed and at least 8 years if the target company has a carried forward tax loss.

Tax losses

As of 1 January 2014, tax losses can be carried forward in equal parts over 4 years. Transitional provisions to the Income Tax Act stipulate that any tax losses reported from 2010 to 2013 and not utilized before 1 January 2014 can only be carried forward in four equal portions based on the new rules. There are no restrictions in the tax loss carry forward rules relating to a change of shareholders of a company or a change of its business. Generally, a legal successor may carry forward tax losses declared by a company that was dissolved without liquidation, provided the purpose of the restructuring was not solely tax avoidance.

Tax license (minimum tax)

As of 2014, a concept of a 'tax license' was introduced for Slovak corporate taxpayers. The tax license represented a de facto minimum tax of EUR480, EUR960 or EUR2,880, depending on whether the taxpayer is VAT-registered and whether its turnover exceeds EUR500,000. Tax licenses were abolished as of 1 January 2018. Companies will pay their last tax license for year 2017, if their taxable period is a calendar year. If they apply an off-calendar financial year as their taxable period, the last tax license would be paid for the tax period ending in 2018.

Pre-sale dividend

A pre-sale dividend can only be paid if conditions stipulated by the Commercial Code are met. Dividends paid out of profits derived from 1 January 2004 are not subject to any tax in Slovakia, so it may be beneficial to pay a non-taxable pre-sale dividend to reduce the capital gain on the sale of shares, which is generally taxable. Hybrids are taxable in the hands of the recipient of the underlying income.

Dividends distributed to individuals from profits generated for the periods from 1 January 2011 to 31 December 2012 are subject to Slovak health insurance contributions of 10 percent of the distributed dividends and 14 percent of dividends distributed for 2013 and later periods. This contribution only applies if the recipient is resident in Slovakia for health insurance purposes and also if the shares are not quoted on a stock exchange.

As of 1 January 2017, dividends paid from Slovak companies to tax-resident individuals of tax treaty countries are subject to withholding tax at the rate of 7 percent, if the applicable treaty does not determine otherwise. A withholding tax rate of 35 percent applies to dividends paid by Slovak companies to all residents of non-treaty countries, including individuals and companies. Dividends received by a Slovak tax-resident individual from a treaty country are subject to 7 percent income tax. Dividends received from non-treaty countries by Slovak tax-resident individuals or companies are subject to 35 percent income tax.

Transfer taxes

Under Slovak tax law, a purchase of shares is not subject to a stamp duty, apart from minor administrative fees payable to the commercial register or Securities Register when the change of the shareholders is registered.

Tax clearances

Income tax returns generally must be filed within 3 months of the end of the taxable period. As of 1 January 2010, an automatic extension of this deadline is available to corporate taxpayers, provided they notify the tax authorities that they intend to extend their deadline for the submission of the income tax return by up to 3 months or, if they have taxable foreign-source income, by up to 6 months. The automatic extension is not available to companies in liquidation or bankruptcy whose filing deadlines may only be extended with the approval of the tax authorities.

Choice of acquisition vehicle

In the Slovak Republic, several potential acquisition vehicles are available to foreign investors. Each vehicle has a different tax impact on the foreign investor.

Local holding company

As of 1 January 2018, Slovakia has participation exemption rules for capital gains on sales of shares and ownership interests in Slovak and foreign companies. These rules do not apply to taxpayers whose core business activity is trading with securities.

The conditions for applying the participation exemption are as follows:

— Income from the sale of shares is derived 24 consecutive calendar months or more after the day on which at least a 10 percent share in the registered capital of the target company was acquired (and this period starts on or after 1 January 2018).

— The seller uses personnel resources and material equipment to perform substantial functions in Slovakia and bears and manages the risks associated with the shares ownership.

Foreign parent company

A foreign parent company can be set up in a jurisdiction, preferably within the EU and/or a country with a beneficial tax treaty with Slovakia that provides for the participation exemption for dividends and capital gains.

Non-resident intermediate holding company

It is also possible to use a non-resident intermediate holding company that holds the shares in the Slovak company.

However, where relief will be sought under the EU Interest and Royalties Directive or a tax treaty, the principle of beneficial owner of interests and royalties and the applicable anti-tax avoidance rules must be taken into account when deciding what transactions should flow through the intermediate holding company.

Local branch

A foreign company may register a branch (*organizacna zlozka*) in the Slovak Republic, which may carry out business activities on behalf of the foreign company in the Slovak Republic from the day of the branch's registration with the Slovak commercial register. The manager of the branch office is entitled to act on behalf of the branch office in all legal matters related to the branch's business activity. A branch generally qualifies as a PE in Slovakia, with certain exceptions.

Joint venture

Joint ventures are common in Slovakia. They are registered normally as limited liability companies. In certain cases, a European Economic Interest Grouping (EEIG) can be considered.

Choice of acquisition funding

A foreign investor must decide how the company established in Slovakia should be capitalized. The company could be funded by:

— equity financing or an increase of registered capital or other capital funds

— debt financing through a loan granted directly by a shareholder or by a related or unrelated third party

— a combination of equity and debt financing.

Hybrids are not frequently used in Slovakia, and their tax treatment is not beneficial to the recipient of the income from hybrid financing.

Debt

Thin capitalization rules were re-introduced by an amendment to the Income Tax Act approved in October 2014. As a result, under so-called 'earnings-stripping' rules for tax periods starting on or after 1 January 2015, interest costs are not tax-deductible in certain cases where they exceed 25 percent of the value of an indicator roughly corresponding to earnings before interest costs, taxes, depreciation and amortization (EBITDA). These rules apply to related legal entities, namely, Slovak tax residents and PEs of tax non-residents. Entities engaged in the financial sector are exempt. The restriction of tax-deductibility of the interest costs does not apply to loans from which the interest is capitalized in accordance with the accounting legislation. Transfer pricing rules continue to apply to debt financing.

Deductibility of interest

Interest on loans used to acquire assets is generally tax-deductible unless it is capitalized, in which case it increases the depreciation value of the assets. In principle, interest on loans used to acquire shares is not deductible where it is deemed not to have been incurred to generate, assure or maintain taxable income on the acquisition of and holding the shares. Such interest is deductible when the shares are sold (if the participation exemption rules do not apply), except for taxpayers whose core business activity is trading with securities. However, debt pushdown schemes may result in tax-deductible interest costs, if properly structured. Where the interest is not set at arm's length terms, the tax authorities may challenge its deductibility.

Withholding tax on debt and methods to reduce or eliminate it

Interest income is subject to 19 percent tax in Slovakia. Interest paid by a Slovak company or Slovak PE to a foreign recipient is subject to 19 percent withholding tax (WHT), unless the EU Interest and Royalties Directive applies or a tax treaty reduces the WHT rate. Slovakia has a wide network of tax treaties, including treaties with most European countries, under which WHT on interest is reduced to 0 percent (see the table of treaty WHT rates at the end of this report).

As of 1 March 2014, a 35 percent WHT applies to 'non-treaty country taxpayers'. Treaty countries include countries with which Slovakia has either concluded a tax treaty and countries that are signatories to other agreements covering exchange of information to which Slovakia is also a party.

Checklist for debt funding

- Check whether the EU Interest and Royalties Directive may apply to the interest payments.
- Where the EU Interest and Royalties Directive cannot apply to avoid or reduce WHT on interest, determine the country from which it is most beneficial to provide the loan in light of the availability and the provisions of tax treaties.
- Consider where the loan agreement should be signed to avoid unnecessary stamp duties. The agreement can be signed in Slovakia, for example, where there are no stamp duties on loans.
- Determine an arm's length interest rate.
- Prepare transfer pricing documentation that also covers the loan transaction.
- Consider whether the loan will be repaid, capitalized into equity or waived. Waiver of a loan is generally taxable income for the borrower, but structures can be designed to eliminate the taxation.

Equity

Legal aspects

Under the Commercial Code, registered capital represents the financial expression of the total sum of financial contributions and of contributions in kind of all members/shareholders of the company. The Commercial Code also defines the contribution of a member/shareholder as the sum of their financial means and other financially expressible contributions to the company that entitle the member or shareholder to share the results of the partnership's or company's business. The member or shareholder is obliged to contribute its respective pledged contribution to the company and is entitled to participate in the economic results of the company.

Limited liability companies and joint stock companies have an obligation to create registered capital. This should amount to at least EUR5,000 for a limited liability company and at least EUR25,000 for a joint stock company (EUR1 for a simple joint-stock company). Partnerships may have registered capital, but they are not required to.

The registered capital can be increased by monetary contributions (cash contributions), non-monetary contributions (contributions in kind) or both, by shareholders or other persons (who subsequently become shareholders).

Contributions to and increases in registered capital must be approved by a general meeting of the company and registered with the commercial register. The signature of the chairman of the general meeting on the decision of the general meeting

of the company must be verified by a notary public. Cash contributions to a limited liability company must be paid-up within 5 years and to a joint stock company within 1 year.

Non-monetary contributions must be paid-up before the registration of the increase in the registered capital with the commercial register. A contribution in kind normally requires an expert valuation.

In joint stock companies, the increase of the registered capital by subscription of new shares is effective as of the day of its registration with the commercial register. In limited liability companies, the increase of the registered capital is effective as of the day of the resolution on the increase at the general meeting, unless the resolution provides otherwise.

Income from a decrease of registered capital may be subject to tax if the registered capital was previously increased by after-tax profit, as well as the payment of funds from the capital fund created from the contributions made by reallocation of own resources of company´s after-tax profit.

As of 1 January 2016, the Slovak Commercial Code introduced the concept of 'company in crisis" in order to protect the creditors. A company is considered 'in crisis' if it is:

— bankrupt (i.e., insolvent or in default), or

— under threat of bankruptcy (i.e. the share of its equity and liabilities is less than a statutory limit; this statutory ratio is:

  — for 2016, 4:100

  — for 2017, 6:100

  — for 2018 and later, 8:100.

If a company is in crisis, stricter requirements for action by the governing body of the company are applied. Where the governing body that concludes (or could have concluded in light of all circumstances) that the company is in crisis, it is obliged — as required by necessary and professional reasonable diligence principles — to take all measures that would otherwise be taken by another reasonably diligent person in a similar position in order to overcome the crisis.

Tax aspects

Corporate income tax

An increase in the registered capital via a cash contribution generally is not considered income, so it is not subject to corporate income tax.

The recipient of an in-kind contribution of business has the option to apply one of two regimes for the valuation of the acquired assets for tax purposes only in the case of a cross-border transaction:

— Use the fair values resulting from the revaluation of assets and liabilities pursuant to the accounting regulations, and pay tax on any step-up in value (regime 1).

— Use the historical prices determined at the contributor; that is, take over the tax values determined by the contributor. In this case, the step-up in accounting value is not taxed (regime 2).

In the case of a cross-border contribution in kind of individual assets, the recipient should be able to value the acquired assets for tax purposes at their contribution value while any potential step-up in the tax value is taxed (regime 1). Alternatively, the recipient should be able to take over the original tax values of assets to the contributor without paying tax on the potential step-up (regime 2).

A number of tax base adjustments are needed for the contributor and the recipient of the in-kind contribution of a business or a part of a business, depending on the selected tax regime. These adjustments apply, for example, to the treatment of reserves and provisions and the computation of tax depreciation charges. Under certain conditions, the taxation of the potential step-up in the tax value of the assets may be spread over a period of up to 7 years.

The use of historical prices (regime 2) for tax purposes is not possible for in-kind contributions to the share capital within Slovakia as of 1 January 2018.

The fair values tax regime must also be used for mergers, fusions and demergers of trading companies and cooperatives within Slovakia that are entered into on after 1 January 2018.

The historical prices regime may only be applied where:

— the legal successor or recipient of the contribution is a taxpayer located in an EU or EEA member state

— the assets and liabilities of the abolished entity remain in the legal successor's Slovak permanent establishment, and

— this legal successor, in line with the local legislation, takes over the assets and liabilities at historical prices for tax purposes.

Contribution in kind

A contribution in kind under the current legislation is treated in the same way as a sale of assets or a sale of business, as appropriate.

Contributions can be made to other capital funds. It is not necessary to register the increase of other capital funds with the commercial register, but a general meeting of the company must approve the increase.

Hybrids

Hybrids are not frequently used in Slovakia, and their tax treatment is not beneficial for the recipient of hybrid income.

Discounted securities

Discounted securities are not used in Slovakia.

Deferred settlement

In certain circumstances, especially where agreed between related parties, deferred settlement may be reclassified as a loan on which interest is due.

Other considerations

Concerns of the seller

If grants were received by the seller of assets for the original acquisition of those assets, the grants may have to be refunded to the relevant institution and the sale of assets may not be possible.

It may not be possible, under the Commercial Code, for the seller in a share deal to pay a pre-deal dividend. In this case, the seller may require a higher price for the shares.

A sale of a substantial portion of assets may trigger taxation of any revaluation differences arising on a previous merger, demerger, sale or contribution of a business.

Company law and accounting

The Commercial Code is the main legislation governing business activities in the Slovak Republic. The Commercial Code recognizes the following basic legal forms for carrying out business activities:

— joint stock companies

— simple joint-stock companies

— limited liability companies

— general commercial partnerships

— limited partnerships

— cooperatives

— branch offices of foreign companies

— individuals (self-employed).

Legal entities established under EU law have a similar legal status to companies and partnerships in the Slovak Republic.

The most common types of company in the Slovak Republic are the joint stock company and the limited liability company.

Joint stock company

— The joint stock company (*akciova spolocnost* — a.s.) exists independently of its shareholders, who are not liable for the debts and obligations of the company.

— A company may be a private or public joint stock company, depending on the method of subscription for its shares.

— Share capital may not be less than EUR25,000 and is divided into a fixed number of shares of a fixed nominal value. The shares may be in the form of registered shares or bearer shares.

— Preferential shares stipulating the right of a shareholder for preferential payment of dividends may be issued, but the aggregate of their nominal value cannot exceed 50 percent of the nominal value of the share capital.

— A company is not allowed to acquire its own shares but may redeem them under certain conditions.

— A company must create a legal reserve fund at the time of its incorporation of at least 10 percent of its registered capital. The company must replenish the fund annually by an amount prescribed by the articles of association, which may not be lower than 10 percent of the net profits reported in the annual financial statements, until it has attained the limit prescribed in the articles of association, which shall not be lower than 20 percent of the registered capital.

— A company must establish a supervisory board and a board of directors. Members are appointed for terms not exceeding 5 years. Members of the board of directors cannot be members of the supervisory board. If the company has more than 50 full-time employees, the employees have the right to elect one-third of the supervisory board members.

— Under certain conditions, the annual financial statements must be audited by an authorized auditor and published.

— The company must submit the list of shareholders, without undue delay, to the Central Securities Depository of the Slovak Republic.

Simple joint-stock company

— The simple joint-stock company (*jednoduchá akciová spoločnosť* — j.a.s.) is a legal entity combining elements of joint stock company (a.s.) and limited liability company (s.r.o.), while introducing certain simplifications.

— A simple joint-stock company may be established by one or more persons with minimum share capital of EUR1.

— The simple joint-stock company may not be established on the basis of an invitation for subscription of shares.

Limited liability company

— A limited liability company (*spolocnost s rucenim obmedzenym* — s.r.o.) is the most common legal form for a company in Slovakia.

— A company exists independently of its shareholders, who are liable for obligations of the company only up to the amount of their unpaid contributions to the registered capital of the company recorded with the commercial register (limited liability).

— A list of shareholders is publicly available in the commercial register.

— A company must have a registered capital of at least EUR5,000.

— Each shareholder holds their ownership interest (share), which is determined as a ratio between their contribution to the company's share capital and the company's aggregate registered capital, unless the articles of association stipulate otherwise.

— The number of shareholders may not exceed 50.

— Each shareholder must contribute at least EUR750 to the registered capital and at least 30 percent of each contribution must be paid-up before the company files its registration with the commercial register. The aggregate value of the paid-up contributions may not be less than EUR2,500. If one shareholder established the company, the shareholder must contribute the entire registered capital before registration.

— In case of a transfer (or division) of the majority share in a company, the consent of the relevant Tax Office must be obtained.

— A company creates a legal reserve fund at the time and for the amount specified in the Articles of Association. Unless the reserve fund is established on incorporation, the company must establish it using net profits reported in the annual financial statements for the year in which the first profit is booked. The reserve fund shall achieve no less than 5 percent of the net profit but no more than 10 percent of the registered capital.

— The supervisory board is only created where its creation is stated in the Articles of Association.

— The general meeting appoints one or more executives (managing directors), who constitute a statutory body of the company.

— A company with a sole shareholder may not be the only founder or only shareholder of another limited liability company. A natural person may be the only shareholder in three limited liability companies at most.

General partnership

— A general partnership (*verejna obchodna spolocnost* — v.o.s.) is a legal entity formed by two or more partners who are jointly and severally liable for the partnership's obligations with all their property.

— The business name of a general partnership must include the designation '*ver. obch. spol.*' or '*v.o.s.*', unless it includes the surname of at least one of its partners, in which case 'a spol.' is sufficient.

— Each partner is entitled to act on behalf of the partnership, unless the Articles of Association stipulate otherwise.

— A natural person or legal entity may be a partner with unlimited liability in only one partnership.

Limited partnership

— A limited partnership (*komanditna spolocnost* — k.s.) is similar to a general partnership apart from the condition that all but one partner may have limited liability for the obligations of the entity.

— There are two types of partners in this kind of partnership:

  — limited partners, who are liable for the obligations of the entity up to the amount of unpaid contributions to the registered capital of the entity recorded with the commercial register general partners, who have unlimited liability for the limited partnership's obligations.

  — If the business name includes the name of a limited partner, that partner shall bear unlimited liability for the partnership's obligations.

— Only a general partner is entitled to manage the partnership.

Cooperative

— A cooperative (*druzstvo*) must have at least five members (except in the case of two legal entities, where two or more members are allowed). A cooperative may carry out not only business activities but also other activities for the economic or social benefit of its members.

— The members are not liable for the debts and obligations of the cooperative.

— A cooperative must have registered capital of at least EUR1,250, half of which must be paid-up at the time of registration with the commercial register.

— An indivisible fund of at least 10 percent of the registered capital must be created at the time of the cooperative's incorporation and replenished with at least 10 percent of the yearly net profits annually to up to one-half of the registered capital of the cooperative.

Branch office of a foreign company

— A foreign company may register a branch office (*organizacna zlozka*) in the Slovak Republic.

— The branch office of a foreign company may carry out business activity on behalf of the foreign company in the territory of the Slovak Republic as of the day of the branch's registration with the Slovak commercial register.

— The head of the branch office, appointed by the foreign company, is entitled to act on behalf of the branch in all legal matters related to the business activity of the branch.

Self-employed individual

Foreign individuals are entitled to carry out their business activities in the Slovak Republic on registration with the Slovak commercial register. However, individuals residing in EU or Organisation for Economic Co-operation and Development (OECD) countries are entitled to carry out their business activities in the Slovak Republic even without such registration.

European Economic Interest Grouping

Under the Council Regulation (EEC) Nr. 2137/1985 of 25 July 1985, an EEIG can be created in certain circumstances.

Societas Europaea

Under the Council Regulation (EC) Nr. 2157/2001 of 8 October 2001, a European public limited liability company (SE) can be created in certain circumstances.

European cooperative society

Under Council Regulation (EC) Nr. 1435/2003 of 22 July 2003, a European cooperative society (ECS) can be created in certain circumstances.

Group relief/consolidation

Corporate income tax-grouping is not available in Slovakia, but VAT-grouping became available from 1 January 2010.

Transfer pricing

Slovakia's transfer pricing rules broadly comply with OECD transfer pricing guidelines for multinational enterprises and tax administrations.

Under Slovak tax law, where the agreed price in a transaction differs from the fair market price and will reduce the taxable base, and the difference cannot be satisfactorily explained, a fair market price may be substituted for tax purposes. This is always the case where the same legal persons or individuals directly or indirectly participate in the management, control or capital of the parties involved in the transaction.

'Related parties' are defined as economically or personally connected natural persons or legal entities. 'Economic connection' is defined as a direct or indirect participation of more than 25 percent in the share capital or voting rights. 'Personal connection' is defined as a participation in the management or control of the other person.

Moreover, where two or more entities enter into a business relationship for the purpose of reducing a taxable base or increasing a tax loss, these entities are deemed to be related parties.

Under the local tax legislation, the tax authorities are allowed to make transfer pricing adjustments where prices charged between related parties differ from arm's length prices in comparable business transactions, such that the price reduces the Slovak entity's tax base (or increases its tax loss).

Based on a recent amendment of the Income Tax Act, the transfer pricing rules also apply to transactions performed between Slovak related entities. This amendment applies to tax periods starting on or after 1 January 2015 and also to contracts concluded before this date. Formal transfer pricing documentation requirements were introduced as of 1 January 2009. The Slovak Ministry of Finance issues guidance on the contents of the transfer pricing documentation.

Taxpayers are obliged to submit local transfer pricing documentation to the tax authority on its request (i.e. not only in the course of the tax audit) within 15 days of receiving the request.

Dual residency

Dual tax residency is not possible under Slovak tax legislation. Taxpayers are regarded as either Slovak or foreign tax residents.

Foreign investments of a local target company

Any dividends received as distributions of profits derived from 1 January 2004 are not subject to tax in Slovakia, unless their source is hybrid financing. Dividends distributed out of profits generated in 2017 and later that are paid to or received from a resident of non-treaty country are subject to 35 percent tax. Dividends received by Slovak tax-resident companies that were distributed out of profits generated in 2004 and later by tax residents in treaty countries are not subject to tax. Interest income and royalty income are included in the taxable base of the Slovak company and taxed at the rate of 21 percent as of 1 January 2017.

Comparison of asset and share purchases

Advantages of asset purchases

— No assets other than those specifically identified by the buyer are transferred.

— No employment or contractual relationships need to be taken over from the seller unless so desired by buyer or unless employees are associated with specific assets.

— Buyer could offer employment to employees it needs under its own salary and working conditions.

— Purchase price may be depreciated for tax purposes.

— Historical tax liabilities of seller are not inherited.

Disadvantages of asset purchases

— Possible need to renegotiate supply, employment and technology agreements.

— Consideration paid between related parties for selected assets must be arm's length (subject to the comments on transfer pricing between Slovak entities).

— Transaction must not be entered into with intent to prejudice seller's creditors because there is a risk that the seller's liabilities to the prejudiced creditors would de facto follow the assets, and the prejudiced creditors have the right to contest the transaction where there is such an intention.

Advantages of share purchases

— Lower capital outlay (purchase net assets only).

— May benefit from tax losses of target company (subject to limitations).

— May gain benefit of existing supply or technology contracts.

— Buyer may benefit from all permits, licenses and authorizations, unless stipulated otherwise.

Disadvantages of share purchases

— Buyer automatically acquires liabilities of target company (including tax liabilities).

— Liable for any claims or previous liabilities of target company.

— No deduction for purchase price.

KPMG in Slovakia

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Slovenia

Introduction

Slovenia has a small and open economy. These qualities have informed the design of its tax system, which aims at simplicity, as reflected in the limited number of taxes and uncomplicated administrative procedures. Slovenia's business friendliness is evident in its general investment incentives, its special tax regime for new investments in special economic zones and its even-handed treatment of residents and non-residents.

Recent developments

There have been no significant changes in the tax legislation that affect the tax environment for mergers and acquisitions (M&A) since 2007. Partly because of a lack of practical tax experience and limited tax history, however, there are still many open questions in Slovenia about the tax treatment of different transaction structures.

Asset purchase or share purchase

An acquisition in Slovenia can take the form of a purchase of the shares of a company or of a business and assets. The form of acquisition is determined by tax and commercial factors. The transfer of ownership interests is legally simpler than the transfer of numerous assets. It is easier to specify interests or shares purchased than to identify individual assets.

Purchase of assets

A purchase of assets is likely to result in taxation at the level of corporate income tax (CIT) to the seller if a profit on the sale is realized. Any losses incurred by the seller can be used to offset the profit. Generally, historical tax liabilities remain with the seller and are not transferred with the assets.

Purchase price

It is necessary to allocate the total consideration among the assets acquired, and it is generally advisable to specify the allocation in the purchase agreement.

Goodwill

The tax treatment of goodwill generally aligns with its accounting treatment.

Expenses resulting from amortization of goodwill are not tax-deductible. Expenses resulting from impairment of goodwill are recognized for up to 20 percent of the original value. It is also possible to carry forward the excess impairment of goodwill.

Depreciation

Tax depreciation generally is recognized as expenditure in the calculated amount but not exceeding the amount arrived at using the straight-line depreciation method. The maximum annual depreciation rates are as follows:

Depreciation category	Maximum annual depreciation (percent)
Building projects, including investment property	3
Parts of building projects, including parts of investment property	6
Equipment, vehicles and machinery	20
Parts of equipment and equipment for research	33.3
Computers and computer equipment	50
Long-term plantations	10
Breeding and working herds	20
Other assets	10

Source: KPMG in Slovenia, 2018

Tax attributes

Tax losses are not transferred on an asset acquisition. They remain with the company or are extinguished.

Value added tax

Valued added tax (VAT) is levied at the rate of 22 percent on a large number of goods and services, although the supply of goods to another member state of the European Union (EU) or to third countries is exempt from VAT. The transfer of a business as a going concern is outside the scope of VAT, provided certain conditions are met. Professional advice should be sought where land or buildings are being sold because the transferor might bring them within the scope of VAT.

Transfer taxes

Generally, there are no stamp duties on a transfer of assets; however, real estate transfer tax might arise. A transfer of

real estate is generally subject to real estate transfer tax of 2 percent of the purchase price unless VAT is charged.

Purchase of shares

A share deal does not offer the buyer a step-up (capitalization of assets at fair market value) of the assets of the purchased company to increase the depreciation base.

Tax indemnities and warranties

In a share acquisition, the buyer takes over the target company together with all related liabilities. Consequently, the buyer normally requires more extensive indemnities and warranties than in the case of an asset acquisition. For large deals, a due diligence exercise is recommended, including a review of the target's tax affairs.

Tax losses

In general, tax losses can be carried forward indefinitely. However, where direct or indirect ownership of capital or voting rights change by more than 50 percent in a tax year and other statutory conditions are not met, tax losses cannot be carried forward.

Pre-sale dividend

In certain circumstances, a pre-sale dividend may be the seller's preferred option. The dividend payment is unlikely to be subject to Slovenian tax if it is paid to a resident corporate shareholder and reduces the proceeds from the sale and thus, the resulting gain, which may be taxed at 17 percent (the possible exemption of 50 percent of capital gains at corporate shareholder level should be considered; see this report's section on equity).

However, each case must be examined on its facts.

Transfer taxes

There are no stamp duties on transfers of shares in Slovenia.

Choice of acquisition vehicle

Various acquisition vehicles are available to a foreign buyer of a Slovenian business, but there have been few M&A-type transactions so far. As a result, tax practice in this field is still developing. Moreover, the CIT Act stipulates no particular tax treatment for different acquisition vehicles. Most acquisitions in Slovenia are achieved by establishing a new company to buy the target and then merging the target with the buyer, or vice versa.

Choice of acquisition funding

A buyer must decide whether to fund the acquisition by means of debt, equity or a hybrid instrument.

Debt

The principle advantage of debt is the potential tax deductibility of interest. The payment of a dividend does not give rise to a tax deduction.

If it is decided to use debt, further decisions must be made as to which company should borrow the funds and how the acquisition should be structured.

A typical structure uses a Slovenian company as the acquisition vehicle. The company funds the purchase with debt from a related party or a bank and offsets interest paid against the target's profit. Problems may arise where the target's profit is not sufficient to absorb the interest because tax grouping is no longer possible in Slovenia.

Deductibility of interest

Generally, a company's accounting treatment of interest is followed for tax purposes.

There are limitations on the tax-deductibility of interest. In general, taxpayers may deduct all substantiated expenses directly connected to or resulting from the taxable business activity. Interest paid on loans from persons or entities resident in low-tax jurisdictions (listed by the Ministry of Finance) is not tax-deductible.

Interest resulting from financing the acquisition of a target company may be deductible in Slovenia on the level of a buyer, provided the funding complies with Slovenia's thin capitalization and transfer pricing rules.

For mergers (where the buyer merges with a target or vice versa), the possibility of debt pushdown should be investigated case-by-case because, in the tax authority's opinion and established tax audit procedures, such interest is not tax-deductible in Slovenia. This area is still unclear and requires careful attention.

The general transfer pricing rule is that interest charged by affiliated persons is tax-deductible, as long as the interest does not exceed the level of the most recently published (at the time the loan is granted), known and recognized interest rate. The recognized interest rate is determined and published by the minister responsible for finance prior to the beginning of the tax period to which it applies. Non-deductible interest could be mitigated where the company demonstrates that it could raise the loans from a non-related lender on the same terms.

Thin capitalization rules are applicable for interest expenses incurred on loans from qualified shareholders other than banks and insurance companies. A company is regarded as a qualified shareholder if it directly or indirectly holds at least 25 percent of the shares in the other company's capital or voting rights at any time in the tax year. Loans granted by a sister company are treated as loans granted by direct or indirect shareholders for thin capitalization purposes, so they are subject to thin capitalization rules. Additionally, loans granted by a third party and guaranteed by qualified shareholders and loans granted in connection with a deposit held by qualified shareholders (back-to-back loans) should be considered when determining the thin capitalization ratio.

Any interest expense incurred on such loans is not deductible from the CIT base if, at any time in the tax year, the debt-to-equity ratio exceeds 4:1.

Non-deductible interest could be mitigated where the company demonstrates that it could raise the excess loans from a non-related lender on the same terms.

Withholding tax on debt and methods to reduce or eliminate it

Payments of interest by a Slovenian company to a resident or non-resident are subject to withholding tax (WHT) at 15 percent. The rate of WHT may be reduced or eliminated under a tax treaty or, if the recipient is a company resident in another EU member state, under the EU Interest and Royalties Directive.

There is no WHT if the recipient is a resident and notifies the Slovenian-resident payer of its tax number.

Prior approval of the Slovenian tax authorities is needed before the reduced (zero) rate on WHT on interest can be applied.

Checklist for debt funding

— The use of bank debt may avoid thin capitalization and transfer pricing problems and should obviate the requirements to withhold tax from interest payments.

— No group relief is possible.

— In a merger, the possibility of debt pushdown should be investigated on a case-by-case basis. The tax authorities take the view that such interest is not tax-deductible in Slovenia.

— WHT of 15 percent applies on interest payments to non-Slovenian entities unless a lower rate applies under the relevant tax treaty/EU directive and advance approval is obtained.

Equity

A buyer may use equity to fund its acquisition. Slovenia has no capital duty, and stamp duty is not levied on issues of new share.

Companies pay dividend WHT at a rate of 15 percent on each distributed dividend to residents and non-residents of Slovenia. Where a tax treaty stipulates a tax rate lower than 15 percent, the treaty rate applies. There is no WHT where a resident taxpayer notifies the payer of its tax number or where a non-resident taxpayer operating a permanent establishment in Slovenia notifies the payer of its tax number.

No tax is withheld for payments of dividends and income similar to dividends distributed to shareholders on the basis of the EU Parent-Subsidiary Directive where at least 10 percent equity has been held for at least 24 months.

Additionally, dividends are not subject to WHT in Slovenia if the (dividend) income is paid to a non-resident who is a resident of an EU and/or European Economic Area (EEA) member state other than Slovenia and is liable for tax on income in the country of residence. In this case, the dividend recipient cannot claim WHT paid in Slovenia in the country of residence and the purpose of the transaction cannot be a tax avoidance.

When calculating the tax base, the taxpayer may exempt received dividends and similar income, except hidden reserves, if the payer is liable to pay CIT. The exemption also applies to a resident of an EU member state that is liable to pay tax comparable to CIT, provided the taxpayer is not a resident of a country (or in the case of a permanent establishment, not situated in a country) in which the general, average nominal level of tax on corporate profits is less than 12.5 percent.

These provisions also apply to a non-resident recipient if the recipient's participation in the equity capital or management of the person distributing profits is connected with business activities performed by the non-resident in or through a permanent establishment in Slovenia.

Capital gains from the sale of shares are subject to CIT as normal income. Half of the capital gains on a disposal of shares are tax-exempt where these conditions are met:

— The shares represent a participation of at least 8 percent of the capital the voting rights in the company.

— The shares have been held for at least 6 months.

— During the holding period, the taxpayer employed at least one person.

— The participation is not in a company resident in a low-tax jurisdiction.

However, 50 percent of capital losses realized on a sale of shares under the special participation exemption regime is not tax-deductible.

If the seller of the shares is not resident for tax purposes in Slovenia, capital gains from the sale of shares are not subject to CIT, provided the shares sold are not attributable to the seller's permanent establishment in Slovenia.

Tax-neutral restructuring

Tax-neutral restructuring in Slovenia may be done through a merger, division, transfer of assets or exchange of shares. If the requirements of the EU Merger Directive are met, restructuring could be done tax-free.

Tax-neutral domestic reorganization has been possible since Slovenia joined the EU but was limited to Slovenian corporate taxpayers with a legal seat in Slovenia. From 31 January 2008, cross-border mergers also may be carried out by companies having their registered seat in other EU member state and operating in a legal form listed by the EU Merger Directive.

Hybrids

There are no specific tax provisions in the CIT Act dealing with the tax treatment of different hybrids. However, the law stipulates that profit distributed to holders of securities and loans that carry rights of participation in the payer's profits are treated as expenditures similar to dividends.

Discounted securities

The tax treatment of securities issued at a discount to third parties normally follows the accounting treatment. There is no specific provision in the CIT Act regarding the tax treatment of discounted securities.

Other considerations

Concerns of the seller

The tax position of the seller can be expected to have an important influence on any transaction.

In certain circumstances, the seller may prefer to realize part of the value of their investment as income by means of a pre-sale dividend. The position is not straightforward, however. Slovenian individuals are subject to a flat tax rate of 25 percent, with a reduction of the tax rate for every completed 5-year period of ownership of the capital. As a result, the following tax rates apply:

— after 5 years, 15 percent

— after 10 years, 10 percent

— after 15 years, 5 percent

— after 20 years, 0 percent.

Company law and accounting

The Company Act prescribes how Slovenian companies may be formed, operated, reorganized and dissolved.

Business activities in Slovenia are mainly carried out through one of the following legal forms.

Limited liability company (*družba z omejeno odgovornostjo — d.o.o.*)

The limited liability company (LLC) is the most common form of business association. It is a corporate entity with its own legal personality. It has one or more shareholders and share capital of at least 7,500 euros (EUR). Shares are not certified. The purchase and transfer of shares in an LLC requires a written agreement, which must be recorded before a notary (in notarized form). The management of an LLC rests with one or more managing directors appointed by shareholders. The shareholders also control the distribution of net earnings.

Stock corporation (*delniška družba — d.d.*)

The stock corporation is also a corporate entity with its own legal personality. The minimum share capital is EUR25,000. The stock corporation usually has a management board and supervisory board. The management board is in charge for the management of the stock corporation and represents it. The members of the management board are appointed and removed by the supervisory board. The supervisory board monitors the management board and represents the stock corporation in relation to the management board. Members of a supervisory board are elected by the shareholders. Stock corporation shares do not need to be transferred in notarized form.

Other forms

Slovenian company law also recognizes the following forms:

— general partnership (*družba z neomejeno odgovornostjo — d.n.o.*)

— limited partnership (*komandtitna družba — k.d.*)

— limited partnership with share capital (*komanditna delniška družba*)

— *societas Europeae*.

All of these forms are legal entities with their own legal personalities and are subject to CIT in Slovenia.

For the accounting of business combinations in Slovenia, the provisions of IFRS 3 — Business Combinations directly apply.

A business combination is the bringing together of separate enterprises (business entities) into one reporting entity.

Business combinations are accounted for by applying the purchase method. At the acquisition date, the buyer allocates the costs of a business combination by recognizing the acquiree's intangible assets, liabilities and contingent liabilities at their fair value at that date, other than noncurrent assets, which are recognized at fair value less selling costs. Any difference between the cost of the business combination and the buyer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities is accounted for as goodwill.

Group relief/consolidation

There is no group taxation regime in Slovenia.

Before 2007, the tax system allowed the use of a group taxation scheme between resident taxpayers with the permission of the tax authorities, generally for 3 years. Groups were allowed to continue after 2006 until the expiry of the taxation period indicated in the permission.

Transfer pricing

In establishing a taxable person's income, the transfer prices paid by affiliated persons for assets, including intangible assets, and services are considered. The transfer prices should be no less than the prices that comparable assets and service in comparable circumstances would command in a market of non-affiliated persons (comparable market prices).

In establishing a taxable person's expenditures, the transfer prices paid to affiliated persons for assets, including intangible assets, and services are considered. The expenditures should not exceed the comparable market prices.

Comparable market prices are fixed by using either one or a combination of the following methods:

— comparable prices on the free market

— resale prices

— cost supplement

— profit distribution

— net profit rate

— another method.

As defined in the CIT Act, 'affiliated persons' include:

— a taxable resident that directly or indirectly holds no less than 25 percent of the value or number of shares or equity holdings or voting rights of a foreign person

— a foreign person that directly or indirectly holds no less than 25 percent of the value or number of shares or equity holdings or voting rights of a resident

— a legal person that directly or indirectly holds no less than 25 percent of the value or number of shares or holdings or voting rights either of a resident and foreign person, or of two residents

— a natural person(s) or members of their families that directly or indirectly hold no less than 25 percent of the value or number of shares, holdings or voting rights, or participate in the supervision or management either of a resident and a foreign person, or of two residents.

Dual residency

There is no dual residency in Slovenia. Residency is determined by the place of establishment or place of effective management. In Slovenia's tax treaties, the predominant criterion is the place of effective management.

Foreign investments of a local target company

To prevent Slovenian companies from accumulating profits offshore in low-tax countries, a 15 percent WHT applies to payments of certain services to an entity with a registered office or actual management in jurisdictions with general or average nominal CIT rates lower than 12.5 percent and listed on the blacklist (EU countries are exempt).

Additionally, interest costs on loans received from companies with registered offices or actual management in jurisdictions with general or average nominal CIT rates lower than 12.5 percent and listed on the blacklist, are not tax-deductible.

Comparison of asset and share purchases

Advantages of asset purchases

— Possible to acquire only those assets that are desired or only a part of the business.

— If the purchase is funded by debt, the interest may be tax-deductible, provided the assets are used for carrying on taxable business.

— Liabilities usually are not inherited (unless there is a purchase of a business).

— Purchase price of the assets can be depreciated for tax purposes.

Disadvantages of asset purchases

— Approval of shareholders is sometimes required.

— Legally more complicated (e.g. notification of suppliers, change of employment contracts, each individual component needs to be transferred).

— Tax losses are not transferred to the acquiring company.

— May be unattractive to the seller, especially if capital gains from a share sale would be exempt from taxation.

Advantages of share purchases

— Legally simpler (no need for transfer of contracts with suppliers and employees).

— Buyer may benefit from tax losses of the target company.

— Generally, 50 percent of capital gains on the disposal of shares is exempt, in certain conditions.

— Where the seller is not resident in Slovenia and has no permanent establishment in Slovenia, a sale of shares is not subject to CIT.

Disadvantages of share purchases

— Tax depreciation is unaffected by the amount of the purchase price.

— Acquisition of all business-related liabilities.

— If a merger follows the acquisition, the debt pushdown might not be tax-deductible.

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Spain

Introduction

This report explains how recent tax changes are likely to affect the approach to mergers and acquisitions (M&A) in Spain. The report then addresses three fundamental decisions faced by a prospective buyer:

— What should be acquired: the target's shares or its assets?

— What should be used as the acquisition vehicle?

— How should the acquisition vehicle be financed?

Tax is, of course, only one part of transaction structuring. Company law governs the legal form of a transaction, and accounting issues are also highly relevant when selecting the optimal structure. These areas are outside the scope of the report. Some of the key points that arise when planning the steps in a transaction are summarized later in the report.

Recent developments

The following summary of recent Spanish tax changes is based on current legislation up to 31 January 2018.

Since the 2016 edition of this report, several modifications affecting M&A transactions have been implemented. Most of these changes were introduced by the Royal Decree 3/2016 approved on 3 December 2016.

Multilateral instrument

In addition to the domestic tax changes discussed below, on 7 June 2017, Spain and 67 other jurisdictions signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (BEPS) and improve dispute resolution mechanisms. Once ratified, the multilateral instrument (MLI) will not override or amend existing bilateral tax treaties. Rather, it will apply alongside the covered tax agreements, modifying their application in order to implement BEPS measures.

The scope of these modifications is still uncertain. Changes under the MLI may take effect in 2019, though some tax treaties may be affected sometime in 2018. Developments concerning the MLI should be closely monitored in order to evaluate its potential impact on transaction structuring.

New restrictions on carry forward of tax losses

For tax periods starting on or after 1 January 2016, new limitations on carry forward of tax losses were introduced for large companies:

— Taxpayers with turnover in the 12 months before the beginning of the relevant fiscal year (FY) of at least 60 million euros (EUR) may only offset 25 percent of their positive tax base, before the capitalization reserve.

— This threshold rises to 50 percent for companies whose turnover in the 12 months before the beginning of the relevant FY is between EUR20 and EUR60 million.

— Taxpayers with turnover below EUR20 million in the 12 months before the beginning of the relevant FY may only offset 60 percent of their positive tax base (70 percent for FYs starting in 2017).

— In any case, a EUR1 million threshold of tax losses applies.

When entities are included in a tax group, the above limits apply to the taxable base of the group as a whole.

Limitation on generated or carried forward tax credits

To avoid domestic or international double taxation, for taxpayers with turnover of EUR20 million or more in the 12 months before the beginning of the relevant FY, the amount of tax credits generated in the FY or carried forward from previous FYs cannot jointly exceed 50 percent of the tax payable (before deducting the tax credits).

The excess can be deducted in following FYs, together with the tax credits generated in the relevant FY, subject to the thresholds noted above but without any timing limitation.

Recapture of pre-2013 portfolio impairments

A new regime is introduced to revert the portfolio impairments that were tax-deductible in tax periods beginning before 1 January 2013 (under article 12.3 of the Spanish Corporate Income Tax (CIT) Law then in force).

Until FY 2013, the former law allowed partner entities to deduct recorded and unrecorded (i.e. no accounting registration was required) portfolio impairments from the decline in value of direct interests held in their subsidiaries.

As of FY2013, this tax regime is abolished and a transitional regime was established to recapture amounts deducted in prior years. Under this regime, the expense deducted in prior years had to be added back to the taxable base if the equity

of the subsidiary at year-end exceeded the equity at the beginning of the FY (no accounting registration is required) and/or the relevant subsidiary distributed a dividend, unless the dividend was not recognized in accounting income.

Under the rules now in force, taxpayers that deducted the impairment for tax purposes and have not completely added it back to the CIT base are subject to 'minimum clawback rules' requiring them to at least recapture the portfolio impairments that were tax-deductible in tax periods beginning before 1 January 2013, in equal parts for each of the first 5 tax periods beginning on or after 1 January 2016 (i.e. 20 percent per FY) unless the depreciated shares were transferred. In that situation, the reversion would be included in the same tax period as the transfer, up to the positive income resulting from the transfer. Where the transitional rules determine that the expense must be added back over a shorter period, the recapture must be carried out according to the transitional rules.

Recapture of losses of non-Spanish permanent establishments

Before 2013, losses from a permanent establishment abroad could be considered as tax-deductible for CIT purposes.

For tax periods starting on or after 1 January 2016, new limitations apply when a taxpayer transfers a permanent establishment at a gain. In this case, the tax-exempt amount equals the gain reduced by the sum of net losses incurred by the permanent establishment before FY2013 that exceed the net profit generated by the permanent establishment from FY2013 onward.

Minimum corporate income tax interim payment

Interim payments must be calculated under the 'base method' or 'quota method', depending on prior FY's net turnover of the taxpayer (individual company when taxed on a stand-alone basis or tax group when taxed on a consolidated basis). Where the net turnover in the prior FY exceeds EUR6 million, the base method applies.

In the base method, the base of the interim payment is calculated on the accounting result corresponding to the first 3, 9 and 11 months of the calendar year, taking into account the corresponding book-to-tax adjustments according to the CIT Law.

The amount is determined by applying a 24 percent rate where turnover during the 12 months before the beginning of the relevant FY is at least EUR10 million, or 17 percent if turnover is lower.

As of FY 2016, a minimum CIT payment on account is required for entities/tax groups with net turnover exceeding EUR10 million (in the 12 months before the start of the FY). The minimum CIT payment has been fixed at 23 percent of the positive after-tax P&L result of the first 3, 9 and 11 months of each calendar year.

Three advance CIT payments of the annual tax payment must be made during the first 20 calendar days of April, October and December. The final CIT payment must be made with the annual CIT return.

Annual CIT returns must be filed within 25 calendar days following the 6 months after to the end of the tax year (i.e. if the tax year coincides with the calendar year, the return must be filed between 1 July and 25 July of the following calendar year). The CIT payments on account are estimates that reduce the final CIT payable in the following year.

Losses on transfer of shares and permanent establishments qualifying for participation exemption

For tax periods starting on or after 1 January 2017, losses on the transfer of shares qualifying for the Spanish participation exemption regime are not tax-deductible for CIT purposes. The same tax treatment is given to the losses derived from the transfer of shares in non-Spanish resident entities that are tax haven residents or do not comply with the so-called "subject-to-tax" requirement (i.e. the non-Spanish resident entity must be subject to a CIT similar to the Spanish CIT at a minimum 10 percent rate). The Spanish CIT Law presumes that this test is passed when the company is resident in a country that has signed a tax treaty with Spain with an exchange of information clause).

Losses arising on the liquidation of a subsidiary are tax-deductible unless the liquidation is part of certain types of reorganizations (regardless of whether the tax rollover regime applies). In any event, any loss that is deductible for CIT purposes must be reduced by dividends received in the previous 10 years in which they were exempt or entitled to claim a tax credit). Similar tax treatment is given to the losses derived from the sale of a permanent establishment are no longer deductible, while losses derived from closing a permanent establishment may be considered as tax-deductible for CIT purposes. In the latter case, the loss is reduced by the sum of the profit from the permanent establishment that benefitted from the participation exemption in earlier years.

2014 tax reform

On 28 November 2014, the Spanish government approved one of the most far-reaching reforms of the Spanish tax system in the recent years. As a result, as of January 2015, most transactions performed in Spain are covered by the new CIT law (Law 27/2014), which incorporates the tax regime for mergers, splits and other reorganization transactions covered in European Union (EU) directives. This tax regime, which can be complex, should be considered at each phase of an acquisition. Specific anti-avoidance provisions may apply, and local advice should be sought.

The new CIT Law was amended in line with the Organisation for Economic Co-operation and Development's (OECD) final recommendations under its Action Plan on BEPS.

The following sections summarize the tax rules in place that affect M&A transactions following the Spanish tax reform.

Corporate income tax rate

The standard CIT rate is 25 percent. Other reduced rates can apply for special entities.

Additional limitation for leveraged buy-out (LBO)

As of 1 January 2012, two limitations affecting to the tax deductibility of financial expenses were introduced in the Spanish CIT law:

— so-called 'earnings-stripping' tax rules, which derogated and substituted the previous 'thin-capitalization' regime

— a specific limitation preventing the deductibility of financial expenses incurred on acquiring participations from other group entities or for making capital contributions into other group entities.

Law 27/2014 also introduced an 'anti-leveraged buy-out' (anti-LBO) provision restricting the deductibility of acquisition financing as of 1 January 2015. The CIT law provides for a rule that limits the tax-deductibility of interest accruing on acquisition debt, where such interest can be offset against the taxable profits of the target entities acquired (through the applicability of the fiscal unity regime or a post-acquisition merger).

Under the anti-LBO rule, for purposes of assessing the 30 percent operating profits threshold applicable under the earnings-stripping rules, the operating profits of the target entities acquired (and which were included in the acquirer's fiscal unity, or merged with or into the acquirer) should be excluded.

Several limitations to this rule should be considered:

— This rule only applies within the 4 years following the leveraged acquisition (i.e. the inclusion of an entity in a fiscal unity, or the performance of a post-acquisition merger after the fourth anniversary of the acquisition, should not trigger the anti-LBO rule).

— Under an 'escape clause', this rule does not apply if the portion of the purchase price financed with debt does not exceed 70 percent of the total purchase price. In later FYs, the applicability of the escape clause requires the amortization of the principal amount of the acquisition debt on an annual basis (at a 5 percent rate) until the principal amount is reduced after 8 years to 30 percent of the purchase price.

— This regime entered into force with retroactive effect from 20 June 2014. In practice, this means that if the target company belonged to the acquirer's fiscal unity before that date (i.e. both were taxed under such fiscal unity regime in a FY starting before 20 June 2014), this regime will not be applicable either.

Tax losses: change of control restrictions

The CIT law restricts the transfer of tax losses on a change of ownership where:

— the majority of the capital stock or the rights to share in the income of the entity has been acquired by a person or entity or by a group of related persons or entities after the end of the tax period to which the tax losses relate

— such persons or entities hold less than 25 percent at the end of the tax period to which the tax losses relate

— the acquired entity:

  — has not performed any economic operations in the 3 months before the acquisition

  — has performed a different or additional economic activity during the 2 years after the acquisition that generates a net turnover value over the 50 percent of the net turnover corresponding to the 2 prior years

  — is a 'passive holding company', as defined in the Spanish CIT law, or

  — has been removed from the index of organizations for not filing its CIT return corresponding to 3 consecutive tax periods.

Period to review tax losses and tax credits

The statute of limitations period is 10 years from which an entity generates tax losses and/or tax credits (the general limitation period is 4 years). Once this 10-year limitation period has elapsed, the Spanish tax authorities cannot review the correctness of the calculation of carried forward tax losses (or tax credits), but the taxpayer should be able to provide:

— the tax return of the tax period in which the carried forward tax loss (and/or tax credit) was generated

— the official accounting records of the FY when the tax loss (or tax credit) were generated filed with the Spanish Commercial Registry.

Participation exemption regime

As of FY2015, the participation exemption regime is extended to dividends or capital gains from Spanish subsidiaries, provided certain requirements are met:

— The Spanish entity must hold, directly or indirectly, at least 5 percent of the share capital or equity of the Spanish or foreign companies or, failing this, an acquisition value of at least EUR20 million.

— A 1-year uninterrupted holding/maintenance period is met.

— The subsidiary is subject to a minimum level of (nominal) taxation of 10 percent under a foreign corporate tax system similar to the Spanish CIT (non-resident subsidiaries only). This requirement is deemed to be met when the foreign subsidiaries are resident in a country that has signed a tax treaty with Spain that includes an information exchange clause.

The CIT law also introduced a system for calculating exempt dividends and gains derived from multi-tiered structures where some of the entities within the chain of ownership are not compliant with the participation exemption requirements.

This exemption does not apply to capital gains derived directly or indirectly from:

— entities passively holding assets

— Spanish or EU economic interest group

— controlled foreign companies (CFC) obtaining more than 15 percent of 'passive income' as defined by the CFC rules (which may imply checking compliance with the substance requirement at the level of the CFC).

The exemption does not apply to any gains on the transfer of holdings in entities resident in a country or territory classified as a tax haven, unless they reside in an EU member state and can demonstrate that their formation and operations are based on valid economic reasons and they engage in economic activities.

Neutralization of the effect of hybrid mismatches

Law 27/2014 introduced certain amendments to anti-abuse rules in accordance with the OECD BEPS project.

In this respect, the deductibility of expenses is disallowed with respect to related parties that, due to a different classification for tax purposes, do not generate income, generate exempt income or are taxed at a rate of less than 10 percent (hybrid transactions).

Additionally, intragroup profit-participating loans (PPL) are characterized as equity instruments for Spanish tax purposes. As a consequence, interest payments with respect to PPLs granted as of 20 June 2014 by an entity belonging to the same group would be assimilated to dividend distributions, so they would not be considered as a tax-deductible expense, regardless of the tax residency of the lender. (Under previous tax legislation, interest accrued under PPLs was tax-deductible where it complied with the general tax rules for the deductibility of financial expenses).

Capitalization reserve

The capitalization reserve is a tax benefit effective as of 1 January 2015. Under this benefit, companies can reduce their taxable base in an amount equal to 10 percent of the increase of their net equity during a given year, provided they book a non-disposable reserve for the same amount and keep it on their balance sheet for 5 FYs.

For a tax group, the tax deduction of the capitalization reserve is calculated on a tax group basis, although the accounting reserve can be recognized by any of the tax group's entities.

Tax neutrality regime

Spanish CIT law incorporates the tax regime for mergers, spin-offs and other reorganization transactions covered in EU directives. Generally, asset transfers carried out through such transactions do not have any tax implications (either from a direct, indirect or other Spanish tax perspective) for the parties involved (transferor, beneficiary and shareholder) until a subsequent transfer takes place that is not protected by this regime.

When applying for the benefits of this regime, it is critical to have a relevant sound business reason for the merger, other than merely achieving a tax benefit (i.e. tax saving or deferral).

As of FY2015, this tax neutrality regime was amended as follows:

— The tax neutrality regime is now the general regime for reorganizations unless the taxpayers elect for the general tax regime (taxable).

— Where the Spanish tax authorities challenge the application of the tax neutrality regime on the basis that the transactions have not been carried out for valid business reasons but mainly to obtain a tax advantage, the CIT law expressly provides that the tax authorities can only regularize the tax advantage unduly taken; they cannot claim the tax charge on the unrealized gains of the dissolved entity.

— The CIT law expands the scope of the definition of 'partial spin-off' (*escisión parcial*) that can benefit from the tax neutrality regime. Law 27/2014 allows the regime's application when the transferring entity keeps a controlling stake in a subsidiary.

— Merger goodwill or the step-up of assets on a merger no longer have tax effects (deferred tax liabilities (DTL) may crystallize in this case). The CIT law included transitional rules for acquisitions of shares before 1 January 2015. Double taxation can arise where the shares are purchased from Spanish resident individuals.

— Carried forward tax losses can be transferred together with a branch of activity to the acquiring entity. Under prior legislation, this was only possible if the company owning the tax losses was extinguished (mergers and total spin-offs).

Rule for share premium redemption or share capital reduction

As of 1 January 2015, the repayment of the share premium is deemed as a dividend distribution to the extent of the positive reserves generated during the holding period. If no positive reserves exist, the share premium redemption would not have Spanish tax effects (i.e. it would reduce the tax cost of the shares).

Impairment of tangible, intangible and real estate assets

As of 1 January 2015, losses on the impairment of tangible, intangible and real estate assets, which were previously tax-deductible under certain circumstances, are deductible only if they are sold to third parties or if they are depreciated during their useful life.

Asset tax depreciation

For tax periods starting in 2013 and 2014, Spanish tax law imposed a limitation for 'large-sized companies' (i.e., companies with a turnover of, or being part of a mercantile group with a turnover, exceeding EUR10 million in the preceding financial year). These entities may only take 70 percent of the maximum depreciation rates for tax purposes corresponding to fixed assets.

The depreciation expense considered non-tax-deductible according to the above is deductible on a linear basis over a 10-year period or, optionally, over the remaining lifetime of the assets, for FYs starting in 2015 and later.

To mitigate adverse tax consequences from the reduced CIT rate (which was 30 percent before FY2015), the Spanish CIT law introduced a tax credit that would apply on the recapture of accounting depreciations that were not deducted in FY2013 and FY2014. The rates of this tax credit are 2 percent for 2015 and 5 percent for 2016 and future years. Unused tax credits may be carried forward indefinitely.

Tax treatment of intangible assets and goodwill

Intangible assets, such as patents, may be amortized if they depreciate and have a limited useful life.

Under certain circumstances, goodwill and intangible assets with an indefinite life are amortizable for tax purposes. As of 1 January 2015, the maximum annual depreciation rate is 5 percent. However, for the 2015 tax year, the maximum annual depreciation rate is 2 percent for intangible assets and 1 percent for goodwill. As of 1 January 2015, it is possible to deduct goodwill amortization even in the case of an acquisition by group companies.

Notwithstanding the above, Audit Law 22/2015, dated 20 July 2015, modifies the tax treatment of intangible assets as follows:

— Intangible assets recognized in the accounts fall within a single category: 'intangible assets with a defined useful life'. However, a new subcategory is created: 'intangible assets whose useful life cannot be reliably estimated'. These assets will be amortized over 10 years unless a different period is provided for in another law.

— Goodwill may be included as an asset when it is acquired in 'onerous basis' and, in principle, will be amortized over 10 years.

As a result of these amendments, for tax years starting in 2016 and later, the amortization expense of intangible assets must be recognized for accounting purposes in order to be tax-deductible.

The difference between the accounting percentage (in principle, 10 percent) and the tax percentage (5 percent) requires book-to-tax adjustments in order to determine the taxable base for CIT purposes.

Tax consolidation rules

As of 1 January 2015, in line with several EU court cases, Law 27/2014 allows the application of the tax consolidation regime to those structures where two Spanish companies have a direct or indirect common non-resident shareholder, as long as the latter is not resident in a tax haven for Spanish tax purposes, thereby allowing so-called 'horizontal tax consolidation'. The non-resident shareholder should comply, among others, with the following requirements:

— It owns, directly or indirectly, at least 75 percent of the other company's share capital (70 percent for companies quoted on the stock exchange), and it maintains such ownership and a minimum 50 percent of voting rights in such entities for the entire tax year of consolidation.

— It is not a subsidiary of another company fulfilling the requirements to be regarded as the controlling company.

Finally, permanent establishments of foreign companies will also be able to form part of a tax group, not only as the dominant entity but also as a member of the group.

Controlled foreign company rules

As of 1 January 2015, the Spanish CFC rules were amended to include, among others, additional substance requirements to be met by the foreign subsidiary in order to avoid the imputation of the foreign low-taxed income.

EU directives: anti-abuse rules

The requirements for the application of the EU Parent-Subsidiary Directive and EU Royalties Directive were modified in FY2015 to prevent abusive situations in which the majority of the participation in the parent company was held by non-EU resident companies. Under the amendment, it is necessary in such cases to prove the existence of valid economic purposes and solid business reasons for incorporating the EU parent company.

Tax credits

The new CIT law abolished the reinvestment tax credit (which reduced the effective CIT rate of a capital gain if certain requirements were met) and the environmental tax credit. The tax incentives for intangibles (i.e. research and development (R&D) tax credit, patent box regime) are retained.

Patent box regime

Under a partial tax allowance included in Spanish CIT Law, only 60 percent of income obtained from, among others, the transfer of the 'qualifying intangible assets' (e.g. rights to use or exploit patents, drawings or models, plans, formulas and know-how) is net income ('qualifying income') for tax purposes, where certain requirements are met.

Taxpayers applying this allowance can request an 'agreed prior assessment' from the Spanish tax authorities validating the qualification and valuation of the assets assigned or transferred.

However, the minimum standards for domestic tax provisions recommended under Action 5 of the OECD BEPS project

provide a framework for the patent boxes regimes. These standards aim to ensure that these regimes only rewards only substantial activity ('nexus approach').

Therefore, under the nexus approach only patents, other intangible assets that are functionally equivalent to patents and legally protected, patents defined broadly, copyrighted software and certain other intangible assets qualify for tax benefits under this regime.

Following OECD developments, the EU Code of Conduct Group was established within the framework of the European Council (EC) to monitor the implementation by the EU member states of certain tax measures (as approved by the Council and the member state governments). This group regularly reports on its work, and these reports are forwarded to the EC, usually twice a year.

In 2017, the EU Code of Conduct Group decided that the patent box regimes of some countries, including Spain, did not comply with the nexus approach and urged these countries to change their legislation accordingly.

Spain has indicated that it would adopt new legislation at the beginning of 2018 to align its patent box regime with the OECD requirements. However, details are not yet available, and it is not known when the legislation will be made public and take effect. Future legislative developments regarding the Spanish patent box regime should be closely monitored.

Transfer pricing

Documentation requirements have changed for periods starting on or after 1 January 2016, based on full implementation of the OECD BEPS Action 13 recommendations. For tax periods beginning on or after 1 January 2016, two types of documentation must be maintained:

— a global document for the group (master file)

— a document for each group entity (local file).

The documentation covers domestic and international transactions, except for:

— transactions within the same tax group;

— transactions with a single related party not exceeding EUR250,000.

Additionally, country-by-country (CbyC) reporting obligations apply to Spanish tax resident entities that are the 'head' of a group (as defined under the Spanish commercial law) and that are not at the same time a dependent of any other entity, to the extent that the consolidated group's net turnover in the immediately preceding FY exceeds EUR750 million.

The transfer pricing documentation does not have to be submitted within the Spanish tax authorities but must be available to them on request as of the deadline for filing the annual corporate tax return (i.e. 25 July of the next FY for entities following the calendar year).

Failure to comply with the documentation requirements may result in specific penalties for not maintaining the correct documentation or for not applying the arm's length principle (i.e. setting transfer prices at market value).

Value added tax

The value added tax (VAT) exemption on second supplies of real estate assets can be waived even if the buyer does not have the right to deduct 100 percent of the input VAT borne. This would mitigate the transfer tax cost when the buyer applies the pro rata VAT rule because the real estate asset is partially used for activities that are VAT-exempt.

Asset purchase or share purchase

Generally, a transaction can be performed as a share deal, in which the shares in the target entity are sold, or as an asset deal, in which the assets (and normally the associated liabilities) are the objects of the transaction.

The transfer of shares may allow the seller to mitigate its capital gains tax, for companies through participation exemption rules and for individuals through capital time-based gains reliefs. However, the buyer cannot step-up the tax basis in the assets of the target and inherits any hidden capital gains and contingencies. Losses derived from an intragroup transfer may be compensated with limitations.

The sale of assets normally produces a taxable capital gain for the selling company (25 percent CIT rate), which might be difficult to mitigate (although some tax benefits may be available). However, the acquiring entity gains a stepped-up tax basis. The buyer of shares assumes the liabilities of the company acquired (although they might be covered by indemnities in the sale and purchase agreement), while the acquirer of individual assets does not assume the tax risks of the selling company unless the acquisition is made by one or several persons or entities that continue a going concern.

However, in an asset deal in which a complete business unit is transferred, the liabilities connected to the business are also transferred. In this case, the buyer may limit its liability by obtaining a certificate from the Spanish tax authorities showing the tax liabilities and debts. The liabilities transferred then would be limited to those listed in the certificate.

Purchase of assets

Tangible assets

Most tangible assets, except land, can be depreciated for tax purposes and spread over the period of their useful economic life, provided the depreciation is based on the asset's recorded historical cost or on a permitted legal revaluation.

Special rules establish the specific depreciation percentages in force, which depend on the type of industry and assets involved. A maximum percentage of annual depreciation and a maximum depreciation period are established for each type of asset.

Intangible assets

Intangible assets with finite useful lives are amortized depending on useful life. Intangible assets with indefinite useful life are amortized at a maximum annual rate of 5 percent.

Notwithstanding the above, as of tax years starting in 2016, intangible assets recognized in the accounts fall within a single category: intangible assets with a defined useful life. However, a new subcategory is created: 'intangible assets whose useful life cannot be reliably estimated'. These assets are amortized over 10 years for accounting purposes, unless a different period is provided for in another law.

As a consequence, the amortization expense of intangible assets whose useful life cannot be reliably estimated must be recognized for accounting purposes in order to be tax-deductible.

The difference between the accounting percentage (in principle, 10 percent) and the tax percentage (5 percent) will imply book-to-tax adjustments in order to determine the taxable base for CIT purposes.

Goodwill

The premium paid by a buyer of a business as a going concern could be due to a higher value of the assets acquired or to the existing goodwill. As of tax years starting in 2016, goodwill may be included as an asset when it is acquired in 'onerous basis' and, in principle, is amortized over 10 years for accounting purposes.

As a consequence, the amortization expense of the goodwill must be recognized for accounting purposes in order to be tax-deductible.

The difference between the accounting percentage (in principle, 10 percent), and the tax percentage (5 percent) will imply book-to-tax adjustments in order to determine the taxable base for CIT purposes.

Additionally, the CIT law provides that goodwill and other intangibles arising as a consequence of a merger following a share deal are no longer tax-deductible if the share deal closes in 2015 or later years. The rationale for this tax change is that capital gains incurred by Spanish sellers on the disposal of shareholdings in Spanish entities are no longer taxable, so there is no double taxation to be mitigated.

Depreciation

Most tangible assets, except land, can be depreciated for tax purposes and spread over the period of their useful economic life, provided the depreciation is based on the asset's recorded historical cost or permitted legal revaluation.

Special rules specify maximum depreciation percentages and periods for specific industries and types of asset.

Depreciation rates higher than the officially established or approved percentages can be claimed as deductible expenses where the company obtains permission from the tax authorities or can support the depreciation applied.

As of FY2015, the limitation of the tax deduction for the depreciation of assets established during FY2013 and 2014 is eliminated.

Tax attributes

Pending tax losses and tax deduction pools are not transferred on an asset acquisition. They remain with the company or are extinguished. However, in certain cases, under the tax neutrality regime for reorganizations, it may be possible to transfer such tax attributes to the acquiring company.

Value added tax

VAT generally applies to the supply of goods or services by entrepreneurs and professionals, as well as to EU acquisitions and the importation of goods by all persons. The standard VAT rate is 21 percent.

Among others, VAT does not apply to transfers of sets of tangible or intangible elements that belong to a taxable person's business or professional assets and constitute an independent economic activity capable of carrying on a business or professional activity on their own, regardless of any special tax regime that may apply to the transfer.

The buyer may deduct the VAT paid on inputs from the VAT charged on outputs and claim a VAT refund where the VAT paid exceeds the VAT charged monthly or quarterly. However, VAT paid on certain inputs, such as travel expenses, gifts and passenger cars, is non-deductible.

Transfer taxes

Corporate reorganizations defined in the tax-neutrality regime for CIT purposes are not subject to the 1 percent capital duty and are exempt from transfer tax and stamp duty. Also exempt from 1 percent capital duty are contributions in cash or in kind to the share capital or equity of a company and the transfer to Spain of the legal seat of a non-EU company.

Sales of real estate exempt from VAT (i.e. a second transfer of a building) are subject to a transfer tax at the rate established by the region in which the real estate is located, unless certain requirements are met and the transferor waives the VAT exemption. Sales of real estate included in a going concern may not be subject to VAT and thus are subject to transfer tax, without the possibility to elect being subject to VAT.

Stamp duty also applies to transactions, such as a sale of real estate, where the sale is subject to VAT and/or the taxpayer waives the VAT exemption on the transfer. There is compatibility between VAT and stamp duty.

Local taxes

Transfers of urban land (whether built on or not) are subject to a municipal tax on the increase in the value of urban land (TIVUL). TIVUL tax due depends on the holding period of the property and the land's cadastral value. The taxable base of the tax is determined by applying to the cadastral value of the land at the disposal date a certain percentage determined by multiplying the number of years the land was held (maximum 20 years) by a coefficient ranging from 3 to 3.7. The tax rate may be up to 30 percent.

Purchase of shares

Due diligence reviews

In negotiated acquisitions, the seller usually makes the target company's official books and tax returns available to the buyer for due diligence review. An important part of the due diligence process is an in-depth review of the tax affairs of the potential target company by the advisors to the buyer.

Local or state taxes

No local or state taxes are payable on the transfer of shares.

Tax indemnities and warranties

In negotiated acquisitions, it is common practice for the buyer to ask the seller to provide indemnities or warranties for any undisclosed liabilities of the company to be acquired.

Tax losses

Tax losses under Spanish law can be carried forward without temporal limitation (an 18-year expiration period previously applied).

The tax losses cannot be offset where:

- the majority of the capital stock or of the rights to share in the income of the entity has been acquired by a person or entity or by a group of related persons or entities after the end of the tax period to which the tax losses relate
- such persons or entities hold less than 25 percent at the end of the tax period to which the tax losses relate, and
- the acquired entity:
  - has not performed any economic operations in the 3 months before the acquisition, or
  - has performed a different or additional economic activity during the 2 years after the acquisition that generates a net turnover value over the 50 percent of the net turnover corresponding to the 2 prior years, or
  - is a 'passive holding company' as defined in the Spanish CIT law, or
  - has been removed from the index of organizations for not filing its corporate income tax return for 3 consecutive periods.

As of FY2016, there are limitation on carry forward of the tax losses (see 'New restrictions on carry forward of tax losses' earlier in this report).

Transfer taxes

VAT and transfer tax are not payable on the transfer of shares, except in certain cases mainly involving the sale of shares as a means of selling real estate. In such cases, where more than 50 percent of the company's assets by value consist of real estate not linked to its business activity and the acquirer receives more than 50 percent of the company's voting rights directly or indirectly, the transfer of the shares may be subject to VAT or transfer tax, to the extent that the parties involved in the transfer of shares act with the intent of avoiding the tax otherwise due on the transfer of immovable properties.

Stamp duty is not payable, but brokerage or notary fees, which are normally less than 0.5 percent of the price, are applicable.

Choice of acquisition vehicle

Several potential acquisition vehicles are available to a foreign buyer, and tax factors often influence the choice.

Local holding company

A local holding company is the most common vehicle for transactions. There are two main types of limited liability companies: *Sociedad Anonima* (SA) and *Sociedad de Responsabilidad Limitada* (SL).

Both entities have their own legal status (legal personality). Each has a minimum share capital (EUR60,000 for an SA and EUR3,000 for an SL) and may have one or more shareholders. Both are governed by Royal Legislative Decree 1/2010, dated 2 July 2010, on Corporate Enterprises.

Foreign parent company

Spain does not charge withholding tax (WHT) on interest and dividends paid to EU recipients (see the European Council Interest and Royalties Directive 2003/49/EC and the EU Parent-Subsidiary Directive 90/435/EEC).

Some tax treaties reduce the applicable WHT rates, which are normally 19 percent for interest and dividends and 24 percent for other income.

Non-resident intermediate holding company

Where the foreign country taxes capital gains and dividends received from overseas, an intermediate holding company resident in another territory could be used to defer this tax and perhaps take advantage of a more favorable tax treaty with Spain. However, the buyer should be aware that certain Spanish treaties contain anti-treaty shopping provisions that may restrict the ability to structure a deal in a way designed solely to obtain tax benefits. Similarly, where the non-resident intermediate holding company reduces the Spanish WHT rate otherwise applicable, Spanish tax authorities may apply general anti-avoidance tax rules (GAAR) to challenge this structuring.

Local branch

The target company's assets or shares can be acquired through a branch. Although branches are taxed in a similar way to resident companies, they have the advantage of not attracting WHT on remittance of profits abroad, provided the foreign company resides in a tax treaty country or in the EU (with some exceptions).

Joint venture (and other vehicles)

Spanish partnerships engaged in business activities (*Sociedad Colectiva or Sociedad Comanditaria*) are treated as corporate taxpayers.

Choice of acquisition funding

A buyer using a Spanish acquisition vehicle to carry out an acquisition for cash needs to decide whether to fund the vehicle with debt, equity or a hybrid instrument that combines the characteristics of both. The principles underlying these approaches are discussed below.

Debt

The investment may be financed on either the local or a foreign market. No limitations apply to local financing, provided the borrower is a Spanish resident. If the loan is granted by a non-resident, under the current exchange control system, the borrower must declare the loan to the Bank of Spain. Previously, the borrower had to obtain a number of financial operation by filing the appropriate form (PE-1 or PE-2), depending on the amount of the loan.

The principal advantage of debt is the potential tax-deductibility of interest (see 'Deductibility of interest' later in this report), whereas the payment of a dividend does not give rise to a tax deduction. Another potential advantage of debt is the deductibility of expenses, such as guarantee fees or bank fees, in computing trading profits for tax purposes.

If it is decided to use debt, a further decision must be made as to which company should borrow and how the acquisition should be structured. To minimize the cost of debt, there must be sufficient taxable profits against which interest payments can be offset.

Normally, the pushdown of debt has been a structuring measure to allow the offsetting of the funding expenses against the target's taxable profits.

Debt pushdowns implemented as intragroup transfers of shares are restricted as of 1 January 2012. Interest expenses are not deductible when derived from intragroup indebtedness incurred to acquire shares in other group companies, whether resident or not, unless the taxpayer provides evidence that the transaction is grounded in valid business reasons.

Additionally, the CIT rule introduced an anti-LBO article. According to this rule, for purposes of assessing the 30 percent operating profits threshold applicable under the earnings-stripping rules described earlier, the operating profits of the target entities acquired (and which were included in the acquirer's fiscal unity, or merged with or into the acquirer) should be excluded.

Both joint stock companies (SA) and limited liability companies (SL) are barred from providing financing, fund assistance or guarantees for the acquisition of their own shares/participation or the shares/participation of their parent company. This restriction does not apply to companies lending in the ordinary course of their business or to loans made to employees.

Deductibility of interest

In addition to transfer pricing rules, there are other limits on the deduction of interest expenses on debt used to finance an acquisition, such as the general limitation on financial expenses and GAAR.

As of 1 January 2012, the deductibility of a company's net financial expenses is limited to up to 30 percent of the EBITDA. Undeducted expenses may be carried forward without temporal limit. Where the net interest expenses of a taxable year are below the 30 percent limit, the unused difference (up to 30 percent of earnings before income taxes, depreciation and amortization — EBITDA) can be carried forward for 5 years. The 30 percent limit does not apply to net expenses up to EUR1 million.

Additionally, there are a number of situations in which a tax deduction for interest payments can be denied under increasingly complex anti-avoidance legislation. In particular, Spanish transfer pricing legislation, which applies to interest expenses and principal amounts, can restrict interest deductibility when the level of funding exceeds that which the company could have borrowed from an unrelated third party or where the interest rate charged is higher than an arm's length rate.

Transactions caught by the rules are required to meet the arm's length standard. Thus, where interest paid to an overseas (or Spanish) parent or overseas (or Spanish) affiliated company is in an amount that would not have been payable in the absence of the relationship, the transfer pricing provisions deny the deduction of the payments for Spanish tax purposes. According to the literal wording of the law, where both parties to the transaction are subject to Spanish tax, the authorities can adjust the results of the party whose benefits have been increased, so that there is usually no impact on the cash tax payable by the group (although losses can become trapped in certain situations).

The tax authorities could also reject the tax-deductibility of interest expenses under the anti-avoidance clauses in the general tax law (i.e. re-characterization of debt into equity).

Withholding tax on debt and methods to reduce or eliminate it

Generally, the payment of interest and dividends by Spanish residents is subject to 19 percent WHT (. The WHT may be credited against the recipient company's income tax liability. Where certain requirements are met, the WHT on dividends is eliminated where the acquiring company holds a participation of more than 5 percent or a participation whose acquisition value has been over EUR20 million during an uninterrupted period of more than 1 year after the date of acquisition.

Additionally, this tax may be reduced or eliminated for dividends, interest and royalties, where the beneficiary is a resident of a tax treaty country.

Checklist for debt funding

— The use of bank debt may avoid transfer pricing problems (but not the limitation on interest deductibility) and obviate the requirement to withhold tax from interest payments.

— Interest can be offset against taxable income of other entities within the tax group. Interest that cannot be offset immediately because of net operating losses can only be carried forward for offset against future profits of the entities within the tax group. Interest that cannot be offset immediately due to the general limitation on interest deductibility may be carried forward without temporal limitation.

— Consider whether the level of profits would enable tax relief for interest payments to be effective.

— A tax deduction may be available at higher rates in other territories.

— WHT of 19 percent applies on interest payments to non-Spanish and non-EU entities unless lower rates apply under the relevant tax treaty.

Equity

It is possible to finance the acquisition with equity and debt. The distribution of dividends from the target to its shareholders as an alternative method of funding the acquisition is tax-assessable, although the shareholder may be entitled to a total or partial tax credit.

Tax-neutral regime for corporate reorganizations

There is a deferral regime in the Spanish CIT law for mergers, spin-offs, contributions in kind and exchanges of shares, among others. This was a special regime; however, as of the FY2015, the deferral regime is the general one. In order to not apply the deferral, the Spanish tax authorities must be notified.

This special regime is mainly aimed at achieving the tax-neutrality of corporate restructuring operations by deferring the taxation that could otherwise arise until the acquiring company transfers the assets acquired.

This tax-neutral regime applies provided that the restructuring transaction is supported with valid business reasons other than tax reasons (anti-abuse clause). In particular, where the main purpose of the reorganization is to obtain a tax advantage and the non-tax reasons are ancillary or not sufficiently relevant compared with the tax advantage obtained, the Spanish tax authorities would likely challenge the tax-neutrality regime.

The new CIT law expressly provides that, if the deferral requirements are not met, the tax authorities can only regularize the tax advantage unduly taken but cannot claim the tax charge on the unrealized gains of the dissolved entity.

M&A transactions

Merger

Three kinds of merger are possible in Spain according to the tax definition of 'merger':

— *Mergers where the companies involved are dissolved (without liquidation) and their assets and liabilities are contributed to a newly incorporated company:* The shareholders of the dissolved companies receive shares in the new company in exchange for their shares in the merged companies and, if necessary, a monetary compensation that cannot exceed 10 percent of the nominal value of the shares.

— *Mergers where an existing company absorbs one or more companies:* The shareholders of the absorbed companies receive new shares from the absorbing company and, if necessary, a monetary compensation that cannot exceed 10 percent of the nominal value of the shares.

— *Mergers where an entity, on being dissolved without liquidating, transfers its assets and liabilities to the company holding all the securities representing its share capital.*

Split

Three kinds of splits are possible in Spain:

— A total split occurs where a company separates its net equity into one or more parts and transfers them as a block(s) to one or more entities (which can be new or pre-existing) as a consequence of its dissolution without liquidation, and the transferring company's shareholders receive representative participation in the acquiring companies. This participation should be given to the shareholders in proportion to the shares they held in the split company, and, if appropriate, a monetary compensation that cannot exceed 10 percent of the nominal value of the shares.

— A partial split occurs where a company separates part of its assets that represent an autonomous branch of activity and transfers it to one or more entities (new or pre-existing), receiving in compensation participations in the acquiring entity that should be allocated to its shareholders in proportion to their respective participations in the transferring entity's share capital. Similarly, the transferring entity reduces its share capital and reserves, and, if necessary, the shareholders of the transferring entity also receive a monetary compensation that cannot exceed 10 percent of the nominal value of the shares.

— A financial split occurs where a company separates part of its assets consisting of the majority shares in other companies (maintaining at least a controlling stake on a subsidiary or a branch of activity) and transfers it to a company (new or pre-existing), receiving as consideration

shares in the acquiring entity that should be allocated to its shareholders in proportion to their participations in the transferring entity's share capital. Similarly, the transferring entity reduces its share capital and reserves, and, if necessary, the shareholders of the transferring entity also receive a monetary compensation that cannot exceed 10 percent of the shares' nominal value.

Where the split involves two or more acquiring entities and the allocation of the shares of the acquiring entities to the shareholders of the transferring company is in a different proportion than their holding in the transferring company, each set of separated assets is required to constitute an autonomous branch of activity.

Contribution in kind

Through a contribution in kind, a company, without being dissolved, transfers an autonomous economic unit of activity to another entity, receiving in exchange shares issued by the acquiring company. The contribution may also consist of individual assets, provided certain requirements are met.

Exchange of shares

In an exchange of shares, an entity acquires a participation in the share capital of another entity that allows it to obtain the majority of voting rights. In exchange, the shareholders of the company acquired are given participation in the acquiring company and, if necessary, monetary compensation that cannot exceed 10 percent of the nominal value of the shares.

Tax treatment

Transferring entity

Generally, the capital gains derived from the difference between the net book value and the market value of the goods and rights transferred as a consequence of the above transactions are not included in the transferor's CIT tax base.

Acquiring entity

The goods and rights acquired by an entity as a consequence of any of the transactions mentioned earlier would be valued for tax purposes at the same value they had in the transferring entity before the transaction took place. The payment of taxes is deferred until the acquirer subsequently transfers the assets involved in the transactions.

Shareholders

The income derived from the allocation of the acquiring entity's participations to the transferor's partners is not added to their taxable bases in certain situations specified in the legislation. For tax purposes, the participations received have the same value as those delivered.

Step-up and goodwill depreciation

The CIT law provides that goodwill and other intangible assets arising as a consequence of a merger are no longer tax-deductible if the share deal closes in 2015 or later years.

The rationale for this change is that capital gains incurred by Spanish sellers on the disposal of shareholdings in Spanish entities are no longer taxable (due to the participation exemption regime), so there is no double taxation to be mitigated. The CIT law provides for transitional rules for shares acquired before 1 January 2015.

Indirect taxation

All the transactions mentioned earlier, except contributions in kind consisting of individual assets, are exempt from or not subject to transfer tax or the local tax on urban land appreciation. These transactions are not subject to VAT where the assets and rights transferred constitute a 'branch of activity', as defined for VAT purposes.

Subrogation in tax rights and obligations

In the above transactions, all of the transferring entity's tax rights and liabilities are transferred to the acquiring company or, in the case of a partial transfer, only those relating to the goods and rights transferred. Where some of the transactions are covered by the special tax regime, the acquiring company can offset losses from the transferring entity, subject to certain limits.

Hybrids

Consideration should also be given to using hybrids, which are instruments treated as equity for accounting purposes for one party and debt (giving rise to tax-deductible interest) for the other. Following the OECD's BEPS recommendations, as of FY2015, expenses derived from operations with related parties that, due to a different qualification, do not generate an income or generate income that is exempt or subject to a tax rate under 10 percent, are not deductible.

Additionally, interest on hybrid financial instruments representing share capital of the issuer (e.g. non-voting shares, redeemable shares) and interest on profit-participating loans granted to group entities are characterized as dividends and could benefit from participation exemption.

The new CIT law also provides a special rule for derivatives when the legal holder of the shares is not the beneficial owner of the dividend, such as stock loans or equity swaps. In these cases, the exemption is granted to the entity that economically receives the dividend (through a manufactured dividend or compensation payment), and not to the formal holder of the shares, provided that certain conditions are met (e.g. accounting recognition of the shares). The participation exemption does not apply to dividends that are characterized as a tax-deductible expense in the entity distributing the dividend.

Deferred settlement

On deferred settlement or payment by installments, income and/or gains are deemed to be obtained on a proportional basis as the payments are made, unless the entity decides to use the accrual method of accounting.

Transactions in which the consideration is received, in whole or in part, in a series of payments or a single late payment are deemed to be installment or deferred price transactions, provided that the period between delivery and the maturity of the last or only installment exceeds 1 year.

Other considerations

Concerns of the seller

Where a purchase of both shares and assets is contemplated, the seller's main concern is the reduction or elimination of the gain derived from the sale. Thus, the following factors should be taken into account:

— A major change in shareholding (see 'Tax losses') and participation in the transferring company by the acquiring company may reduce the loss carry forward benefit if the target company has been inactive for any length of time.

— The date of acquisition is crucial (for real estate only where the seller is a legal entity and for all assets where the seller is an individual, provided certain requirements are met).

Company law and accounting

Spanish accounting legislation was adapted to European legislation by Law 16/2007, which was designed to reform commercial accounting rules and harmonize them with EU rules.

The General Accounting Plan was approved by the Royal Decree 1514/2007.

For accounting purposes, a business combination may be categorized as either an acquisition or an intragroup operation.

In essence, a combination is regarded as a merger where it affects a pooling of business interests (where one company's equity is exchanged for equity in another company) or where shares in a newly incorporated company are issued to the merging companies' shareholders in exchange for their equity, with both sides receiving little or no consideration in the form of cash or other assets.

The acquisition accounting may give rise to goodwill. The net assets acquired are recorded on the consolidated balance sheet at their fair values, and goodwill arises to the extent that the consideration exceeds the aggregate of these values. Acquisition accounting principles also apply to purchases of trade and assets.

An important feature of Spanish company law concerns the ability to pay dividends. Distributions of profit may be made only out of a company's distributable reserves provided that the minimum legal reserved has been recorded. Interim dividends are allowed.

Distribution of pre-acquisition retained earnings of the acquired company should be recorded as a reduction in the value of the participation acquired (for both accounting and tax purposes). In certain cases, even if the dividend is not recognized as taxable income, the buyer could obtain a tax credit to avoid double taxation for the dividend received if enough evidence can be provided of the taxation borne by the seller on the sale of the target shares.

Finally, a common issue on transaction structuring arises from the provisions for financial assistance. Generally, it is illegal for a company to give financial assistance, directly or indirectly, for the purpose of acquiring that company's shares.

Law 3/2009 regulating structural modifications of commercial companies also deals with financial assistance. It stipulates that in the case of a merger between two or more companies, a report by an independent expert on the merger plan is required where any of the companies has incurred debt during the previous 3 years to acquire control over or essential assets from another company participating in the merger. The independent expert must pronounce on whether or not financial assistance has been provided.

According to the criteria of the Spanish accounting authorities, certain waivers of loans or conversions of loans into equity made in the context of a debt restructuring process could trigger accounting income for the borrower, which would be included in its taxable income.

Group relief/consolidation

Grouping of companies for tax purposes is possible provided the dominant company (which must be a resident entity in Spain, unless no Spanish entity meets the dominant company requirements) directly or indirectly holds at least 75 percent (70 percent for listed companies) of the stock of all companies of that group at the beginning of the year in which the tax-consolidation regime is to be applied. This participation must be maintained for the entire FY in which the consolidation regime is applied.

Formerly, the group dominant entity had to be a Spanish entity. However, according to the CIT law, Spanish sister entities with a non-Spanish parent (and Spanish subs indirectly owned) can now form a tax group.

Transfer pricing

The main rule governing transactions between associated parties is that the transactions should be carried out at prices that would have been agreed under normal market conditions between independent companies (i.e. arm's length price).

Dual residency

There are no advantages in Spain for a company with dual residency.

Foreign investments of a local target company

Generally, from an exchange control point of view, foreign investments are unregulated and can be freely made, although they must be declared to the foreign investments registry by filing the relevant forms.

Where the foreign participation in the Spanish company is higher than 50 percent, prior communication with the general directorate of foreign transactions is required when the foreign investor is a resident of a tax haven.

Comparison of asset and share purchases

Advantages of asset purchases

— The step-up in the assets acquired can be depreciated or amortized for tax purposes.

— No previous liabilities of the company are inherited, unless the acquisitions made by one or several persons or entities constitute a going concern (even in this case it is possible to request a certificate of tax liabilities from the tax authorities and limit the liabilities to those disclosed in the certificate).

— Only part of the business may be acquired.

— Where the selling company has tax losses, capital gains can be offset against the seller's tax losses, thereby effectively allowing for immediate use of the losses, with certain limitations.

— Not subject to VAT when a branch of activity is transferred.

— A profitable business can use its acquirer's tax losses.

Disadvantages of asset purchases

— The capital gain derived from the transfer is subject to CIT for the seller unless it arises as a consequence of a corporate reorganization protected by the neutrality tax regime.

— A higher capital outlay is usually involved (unless business debts are also assumed).

— Possible need to renegotiate supply, employment and technology agreements, and change stationery.

— Generally, benefit of any losses incurred by the target company remains with the target company.

— Tax liabilities are inherited when acquiring a business unit.

Advantages of share purchases

— Capital gains on a sale of shares by a Spanish company may benefit from participation exemption if certain requirements are met.

— May benefit from tax losses of the target company (with certain limitations).

— Lower capital outlay (purchase net assets only).

— May gain benefit of existing supply or technology contracts.

— Not subject to VAT or transfer tax (unless anti-avoidance rules apply where real estate is involved).

Disadvantages of share purchases

— Buyer acquires unrealized tax liability for depreciation recovery on difference between market and tax book value of assets.

— Liable for any claims or previous liabilities of the entity.

— Losses incurred by any company in the acquirer's group in the years before the acquisition of the target cannot be offset against profits made by the target company unless a specific restructuring is performed.

— Less flexibility in funding options (requires debt pushdown strategies to offset interest expense with target's business profits).

— The affiliation privilege may not apply on dividends distributed from existing retained earnings.

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Sweden

Introduction

This section explains how the Swedish tax rules affect mergers and acquisitions (M&A) and the key considerations arising from these rules. The balance of this report addresses three fundamental decisions facing a prospective buyer:

— What should be acquired: the target's shares or its assets?

— What will the acquisition vehicle be?

— How should the acquisition vehicle be financed?

Of course, tax is only one part of transaction structuring. Company law governs the legal form of a transaction, and accounting issues are also highly relevant when selecting the optimal structure. These areas are outside the scope of this report, but some of the key points that arise when planning the steps in a transaction plan are summarized later in this report.

Recent developments

The following summary of recent significant Swedish tax developments is based on tax legislation and proposals as at the end of December 2017.

The government is conducting a review of the Swedish corporate tax system. A report proposing revised rules was presented in July 2017. A general limitation on interest deduction in the corporate sector is primarily introduced as an 'EBIT rule', where deduction is capped at 35 percent of earnings before interest and tax (EBIT) and secondarily as an 'EBITDA rule', where deduction is capped at 25 percent of earnings before interest, tax, depreciation and amortization (EBITDA).

Other proposed changes would reduce the corporate tax rate to 20 percent (from 22 percent) and temporarily limit the use of carried forward losses during a 2- or 3-year period, in which only 50 percent of trading profits can be reduced by carried forward losses (with the remainder of carried forward losses available in future years).

Asset purchase or share purchase

An acquisition in Sweden is more often a share purchase rather than a purchase of the company's assets because capital gains on the sale of shares may be tax-exempt.

However, the benefits of asset acquisitions for the buyer should not be ignored, particularly given that purchased goodwill benefits from tax deduction. Some of the tax considerations relevant to each method are discussed below. The relative advantages are summarized at the end of the report.

Purchase of assets

A purchase of assets usually results in an increase in the base cost of those assets for both gains tax and capital allowances purposes (i.e. step-up in value), although this increase is likely to be taxable to the seller. In addition, historical tax liabilities generally remain with the company and are not transferred with the assets.

Purchase price

There are no statutory rules on how the purchase price should be allocated between the purchased assets, although it is recommended that the total consideration should be apportioned among the assets acquired to the greatest extent possible. The remaining part of the consideration that cannot be allocated is booked as goodwill for the buyer.

Under certain circumstances, it is also possible to dispose of assets at tax-residual values, leading to no gain for the seller and no step-up in value for the buyer. This could be useful in a pre-sale restructuring.

Goodwill

Goodwill paid for a business (assets) may be depreciated. The rules for depreciation of goodwill are the same as those for machinery and equipment (see below).

Depreciation

Most tangible and intangible assets may be depreciated for tax purposes under the same rules as machinery and equipment. Two major exceptions are land and shares, which are non-depreciable.

The two main depreciation methods are the declining-balance method, where a maximum depreciation allowance of 30 percent of the aggregated book value is allowed, and the straight-line method, where assets are depreciated by 20 percent annually.

Buildings are depreciated straight-line by approximately 2 percent to 5 percent annually, depending on the building. No tax depreciation on land is allowed.

Tax attributes

Tax attributes, such as tax losses, remain with the selling company and are not transferred with the assets.

Value added tax

Generally, value added tax (VAT) is levied on all commercial supplies of goods or services made within Sweden, unless specifically exempt from VAT. The standard rate of VAT is 25 percent. Certain supplies are subject to reduced rates of 12 percent or 6 percent (e.g. food, hotel accommodation, printed matter, public transportation).

Input VAT on costs incurred is recoverable where the costs are business-related and the business conducted is taxable for VAT purposes. Excess input VAT (i.e. where input VAT exceeds output VAT) is repaid by the Tax Agency.

Goods and services exported from Sweden are normally zero-rated when supplied to customers outside the EU or taxable persons in other EU member states (i.e. no output VAT is charged but full input VAT is recoverable).

VAT is levied on the supply of goods or services within a group. In certain circumstances, it may be possible for related entities to form a VAT group and make intragroup supplies out of the scope of VAT. VAT grouping is primarily available to financial services companies or groups operating in commissionaire structures for income tax purposes.

Financial and insurance services are exempt from VAT (without input VAT recovery possibilities, except for VAT on costs relating to financial services supplied to a buyer outside the European Union — EU).

A transfer of assets in conjunction with the transfer of an entire business or a line of business subject to VAT (i.e. transfer of a going concern) can be considered as out of scope of VAT where certain requirements are met.

Transfers of shares are always exempt from VAT.

Transfers of land and buildings are also exempt from VAT. Where land or buildings are being sold, professional advice should be sought, as additional documentation requirements must be fulfilled.

Foreign companies with no permanent establishment in Sweden may receive a refund of input VAT incurred in Sweden by submitting an application to the tax authorities in their country of establishment (companies based in the EU) or directly to the Swedish Tax Authority (non-EU-based companies).

Recent developments show that the Swedish Tax Agency is becoming ever more restrictive in its approach toward VAT recovery on transaction costs and holding structures. Acquisition structures and future divestments should be considered when determining the possibilities of recovering VAT on transaction costs at the time of acquisition. A careful examination of acquisition structures and post-closing activities of acquisition vehicles is recommended to mitigate VAT leakage.

Transfer taxes

A stamp duty land tax is levied on transfers of real property. The duty, payable by the buyer, is 1.5 percent of the purchase price for individuals and 4.25 percent for corporate buyers. Stamp duty is not charged where shares are transferred in a company holding real property.

The stamp duty on transfers of real property between companies within a group may be deferred until the property in question is sold to an external party, the companies no longer belong to the same group, or one of the companies ceases to exist due to liquidation or bankruptcy. Hence, the buyer should be aware of any deferred stamp duties within the target company or group because the acquisition or a later reorganization may crystallize any deferred stamp duty.

There is no stamp duty or transfer tax on security transactions, formations of companies and branches, or expansions of capital.

Purchase of shares

The purchase of a target company's shares does not result in an increase in the base cost of that company's underlying assets. Hence, there is no step-up in the basis for tax depreciation purposes and the buyer cannot deduct the difference between the underlying net asset values and the consideration for the shares.

Transactions costs, such as advisory costs, associated with purchases of shares may only be tax-deductible where the deal is not closed.

Sales or transfers of shares are VAT-exempt. Input VAT on costs related to share purchases may be recoverable, provided certain conditions are met. Input VAT on costs related to share sales is currently not recoverable in Sweden.

Tax indemnities and warranties

In a share acquisition, the buyer is taking over the target company, together with all related liabilities, including contingent liabilities. Therefore, the buyer normally requires more extensive indemnities and warranties than they would in an asset deal. An alternative approach is to transfer the target's business to a newly formed subsidiary so the buyer can take over a clean company. However, such pre-structuring transactions may result in taxable income for the seller.

With large and medium-sized negotiated acquisitions, it is common for the seller to open the books of the target company to the prospective buyer for a due diligence review.

A normal part of the due diligence process involves an in-depth review of the tax affairs of the potential target company by the buyer's advisors.

Reassessment of final tax returns by the Swedish Tax Agency is possible until the end of the year following the assessment year. However, in the case of incorrect and/or omitted information in the tax returns, the period for reassessment is extended to 5 years.

Tax losses

Under Swedish tax rules, tax losses may be carried forward indefinitely. Tax losses carried forward may be transferred with the company. However, following a change of control in a company (i.e. where another enterprise has obtained a decisive influence over the company), the right to deduct losses may be restricted. In this case, any tax loss carried forward from the year before the acquisition year exceeding 200 percent of the cost to acquire the decisive influence over the company may be forfeited (the so-called 'amount limitation rule').

Where equity injections (e.g. unconditional shareholder contributions and any proceeds from a rights issue) have been made during the year in which the change of ownership took place (up to the change of control) or in either of the 2 preceding years, the consideration must be reduced by the corresponding amount when calculating any surviving tax losses.

In addition to the amount limitation rule, any tax loss carry forward that survives the change of control is restricted in time for 5 years following the year in which the change of control took place. During this period, the acquired company may not offset those losses against profits in any company belonging to the buyer's group (the so-called 'offset restriction rule'). However, where the company itself generates a profit after the change of control, the company may offset its tax losses against those profits. No limitations apply to losses incurred in the year of acquisition or in later years.

Transfer taxes

There is no stamp duty or transfer tax on security transactions, formations of companies and branches, or expansions of capital.

Tax clearances

It is not possible to obtain a clearance from the Swedish Tax Agency giving assurance that a potential target company has no tax arrears or that it is not involved in a tax dispute.

Choice of acquisition vehicle

Several potential acquisition vehicles are available to a foreign buyer, and tax factors often influence the choice. As already noted, there is no capital duty on the introduction of new capital to a Swedish company or branch.

Local holding company

Profits and losses within a Swedish group of companies may be equalized by means of group contributions. Group contributions may be made between a parent company and its subsidiaries where more than 90 percent of the share capital is owned for both the parent's and the subsidiary's entire financial year or since the subsidiary started to conduct business (qualifying period).

Group contributions can also be made between such subsidiaries, subject to certain other conditions. Group contributions are tax-deductible for the payer and taxable for the recipient.

Group contributions between Swedish subsidiaries of a foreign parent company are granted under Swedish law, provided the foreign company is situated in an EU country, Norway, Iceland or Liechtenstein.

Foreign parent company

The foreign buyer may choose to make the acquisition itself, perhaps to shelter its own taxable profits with the financing costs. This should not cause any tax problems in Sweden because the capital gains of non-residents disposing of Swedish shares are not taxed in Sweden.

The buyer may also choose to buy the Swedish shares through a foreign holding company. Sweden has tax treaties with over 80 countries, including all industrialized and almost all important developing countries, and it is common for buyers to review them for favorable withholding tax (WHT) clauses. Sweden levies WHT on dividends but not on interest or royalty payments. In practice, WHT is often eliminated under domestic rules or EU directives. Note that royalty payments may imply a Swedish permanent establishment for the recipient and may be taxed at the statutory income tax rate of 22 percent. This rate is often reduced or eliminated under a tax treaty.

Local branch

As an alternative to the direct acquisition of the target's shares, a foreign buyer may structure the acquisition through a Swedish branch. Sweden does not impose additional taxes on branch profits remitted to an overseas head office. A branch is subject to Swedish tax at the same standard corporate rate as a subsidiary, currently 22 percent. Although the choice of the legal form of an enterprise should be determined on a case-by-case basis, certain factors should always be considered from a tax viewpoint. These factors include the following:

— Profits of a branch are currently taxed in Sweden (the source country) as well as in the home country (the source country tax is normally credited against the home country tax unless an exemption applies). Profits of a subsidiary are taxed in Sweden only. Where profits are distributed by a subsidiary, the dividend taxation of the owner must be examined separately in each case.

— Tax is not withheld on branch profits in Sweden, but distributions from a Swedish subsidiary can be subject to WHT, which is often reduced or eliminated under Swedish law or a tax treaty.

— The disposal of a branch is taxed in Sweden, but the disposal of shares is not.

— Filing requirements are generally more extensive for subsidiaries than for branches.

Joint venture

No special tax legislation applies to joint ventures.

Choice of acquisition funding

A buyer using a Swedish acquisition vehicle to carry out an acquisition for cash needs to decide whether to fund the vehicle with debt or equity.

Debt

Interest on loans is normally deductible for the purpose of calculating the net profits from business activities and where the loan is taken out for the purpose of acquiring shares from an external party. The deduction is made on an accrual basis. Sweden has no thin capitalization rules but does impose rules on the deductibility of interest, discussed below.

Deductibility of interest

Broadly speaking, a company's accounting treatment of interest is followed for tax purposes. However, there are a number of situations in which deductibility of interest can be denied. Under Swedish transfer pricing regulations, an arm's length interest rate must be charged for intragroup debt. The Swedish transfer pricing regulations apply where the parties to an international transaction are related. In particular, deductibility can be partially denied where the interest rate charged by a foreign entity to a Swedish entity is higher than the arm's length interest. Where both parties to the transaction are Swedish entities, transfer pricing regulations are normally not relevant since group relief schemes can be applied where more than 90 percent of the capital is held the entire year. See 'Group relief/consolidation' later in this report.

Under Sweden's main interest deduction rule, tax deduction for interest payments on all loans from affiliated companies may be denied. An 'affiliated company' is a company that, directly or indirectly, through ownership or otherwise, has a significant influence over the other company. Affiliated companies also exist when companies are *primarily* under joint management. The restriction also applies on back-to-back loans; that is, where the loan is routed through a third party, related or unrelated. There are two exemptions to this restriction of interest deduction:

1. Where the beneficial owner within the community of interest is taxed on the interest income at a rate of at least 10 percent and the debt arrangement has not been established primarily to obtain a significant tax benefit (the '10 percent test'). Where the main purpose of the debt arrangement is to obtain a significant tax benefit, the interest is not deductible even though the corresponding interest income has been subject to10 percent tax or more.
2. Where the beneficial owner is taxed on the interest income at a rate lower than 10 percent (i.e. not passing the 10 percent test) but it can be shown that the debt arrangement was established mainly for business purposes (the' business purpose test'), the interest cost is still deductible. However, this possibility only applies where the beneficial owner of the interest is in the European Economic Area (EEA) or a country with which Sweden has a double tax treaty.

Withholding tax on interest, dividend and royalty and methods to reduce or eliminate it

No WHT is imposed on interest payments from Sweden to a non-resident recipient, and there is no WHT or capital tax on repayment of debt.

Dividends paid from a Swedish company to a non-resident shareholder are generally subject to a WHT of 30 percent. However, many foreign companies are exempt from WHT under Swedish law. Dividends paid by a Swedish resident company to a foreign company on business-related shares are exempt from WHT. A foreign company is defined as a foreign legal entity subject to taxation in its country of residence similar to the taxation to which Swedish resident companies are subject. Generally, a foreign legal entity is deemed to be subject to similar taxation where it is subject to a corporate tax rate of at least 10 to 12 percent on its profits calculated under Swedish tax rules. A foreign company covered by a tax treaty is always deemed to be a qualifying foreign company. The foreign company must also be deemed equivalent to a Swedish limited company, from both tax and civil law perspectives.

Unquoted shares are normally deemed to be business-related (and qualify for the exemption) where they constitute fixed business assets. Quoted shares are deemed to be business-related where they:

— constitute fixed business assets of the non-resident company

— have been held by the non-resident company at the time of the dividend payment for at least one year

— represent at least 10 percent of the voting rights that have been held for at least one year in the resident company.

A specific anti-avoidance provision denies a WHT exemption where an otherwise exempt person is receiving the dividend for the purpose of providing another person with a reduced WHT or other tax benefit.

Where not exempt under Swedish rules, WHT is normally reduced or waived under a tax treaty. Treaty reduction or exemption is normally given at the time of payment of the dividend (often subject to the filing of a form), but some treaties provide for a refund procedure.

Royalties paid from Sweden to a non-resident recipient are not subject to WHT. However, such income is deemed to be business profits derived through a permanent establishment in Sweden where the income is considered as business income for the recipient. Thus, tax is levied on a net basis after a normal assessment procedure based on the recipient's tax return. In the course of the normal assessment procedure, treaty reduction or exemption is given on the application of the taxpayer in their tax return.

Checklist for debt funding

— The use of an external bank debt may avoid transfer pricing problems.

— In view of the interest-deductibility restrictions on all loans to an affiliated party, any debt structuring should be carefully monitored.

— Claims and debts in foreign currency attributable to the business activities must be valued at the exchange rate prevailing on the balance sheet date. For companies, exchange gains and losses are fully taxable or deductible, respectively. However, gains/losses are not taxable/deductible where hedge accounting is applied.

— Waiver of third-party debt normally gives rise to taxable income for the borrower where the borrower is not considered insolvent. Waiver of external debt may also be considered as composition with creditors that will affect any tax losses carried forward. Where considered a composition with creditors, any losses are forfeited up to the amount subject to composition.

Equity

A feature of the Swedish tax system is that dividends and capital gains are tax-exempt in certain situations. Sweden has participation exemption rules on dividends and capital gains on shares held by companies for business purposes.

Dividends and capital gains on business-related shares can be received tax-exempt. All non-quoted shares in certain domestic companies (i.e. Swedish limited companies) or corresponding foreign companies are deemed to be business-related. Quoted shares are deemed to be business-related where these conditions are met:

— The owner holds at least 10 percent of the votes, or the shares are otherwise necessary for the business conducted by the shareholder or any of its affiliates.

— The shares are held for at least 1 year.

A Swedish limited liability company may issue different classes of shares, such as preferential rights to profit distribution, which should be considered when capitalizing a company. All classes of shares are subject to the same tax treatment.

In Sweden, tax-neutral mergers are available under certain conditions. Where these conditions are met, a so-called 'qualifying merger' is achieved. In this case, assets and liabilities together with all related rights and obligations are transferred from the transferring company to the receiving company and recorded in the books of the receiving company at the same taxable values as they had in the transferring company. Thus, no gain is recognized on the assets transferred. As no capital gain tax is triggered for the transferring company, no step-up in values is available for the receiving company.

Hybrids

Convertible debentures can be an alternative method of raising capital. The convertible debentures may be converted into shares at the option of the holder within a certain period. Convertible debentures are treated as debt until converted into shares, so any interest paid is deductible under applicable rules. Once converted into shares, any distribution paid out is treated as a non-deductible dividend. The conversion does not give rise to any tax consequences.

Deferred settlement

An acquisition often involves an element of deferred consideration, the amount of which can only be determined later on the basis of the business's post-acquisition performance. The tax treatment of deferred considerations normally follows the accounting treatment.

Other considerations

Concerns of the seller

A total closing-down sale involving all the assets of a company normally constitutes the last transaction of business activity. Accordingly, hidden reserves in various assets, including untaxed reserves, are dissolved and subjected to tax. Where hidden reserves exist, the inevitable consequence for the seller is a tax burden that the company cannot postpone.

The tax consequences arising on selling all the assets of a business carried on in corporate form can be divided into two stages:

— sale of the assets

— transfer of the remaining after-tax capital to the owner.

Normally, when all the assets of a company are sold, the entire gain is taxed. Where the company has unused tax losses, these losses may be used to reduce the taxable

profits. Any remaining profits are taxed as business income at the corporate tax rate.

The stamp tax on the transfer of real property is payable by the buyer and is normally not a concern for the seller.

After the transaction is completed, the remaining capital may be distributed to the owner of the company by means of dividends, liquidation or sale of the shares.

Dividends paid to a parent company by its subsidiary are normally tax-exempt where the shares were deemed business-related.

Capital gains on business-related shares are tax-exempt. However, capital gains on other non-business-related shares are taxed at the normal corporate rate on the difference between the considerations received less the tax basis of the shares. No indexation allowance is granted.

Capital losses on business-related shares are non-deductible. Capital losses on other shares can be offset against capital gains on corresponding shares. The latter losses are also deductible against capital gains on corresponding shares within a group where tax-deductible group contributions are possible. Remaining capital losses may be carried forward indefinitely.

A foreign corporate seller is normally not taxed in Sweden on the sale of shares in a Swedish limited company.

When shares are sold, the seller cannot take advantage of unused tax losses from earlier years in the sold company. The buyer also normally finds it difficult to use such losses in the first 5 years after the acquisition.

The Swedish legislation contains rules on special taxation when disposing of shares in shell companies. A company is regarded as a shell company where the total amount of the liquid assets exceeds one-half of the consideration paid for all the shares. Where a company (Swedish limited company) disposes of shares in a shell company, the taxable amount is the consideration paid for the shares. To avoid taxation on the sale of shares in a shell company, the seller needs to prepare a special tax return and file it with the tax authorities within 60 days of the disposal. Where the company disposed of is a foreign company, shell company taxation may only arise where the foreign company is liable to tax in Sweden at the time of the disposal of its shares or where the foreign company holds a share, directly or indirectly, in a non-quoted Swedish limited company or Swedish economic association.

Company law and accounting

The Companies Act prescribes how Swedish companies may be formed, operated, reorganized and dissolved. The tax law mostly complies with the Companies Act. Domestic mergers are common in Sweden, and both tax and civil law include rules for handling EEA cross-border mergers in line with developments within the EU. A Swedish merger is an amalgamation, as described below.

Amalgamation is a special form of merger in which two or more companies amalgamate into a single entity, which then holds all the property and rights and is subject to the same liabilities as the previous companies. The Companies Act differentiates between three forms of amalgamation:

— absorption generally

— combination

— absorption of a wholly owned subsidiary.

In all forms of amalgamation, one limited company (the transferor) — or in the case of a combination, several limited companies — assigns all its assets and liabilities to another limited company (the transferee), after which the transferor is dissolved without formal liquidation. Absorption of a subsidiary is the most common form of amalgamation in Sweden and is usually the last step in a takeover in which the buyer does not wish the acquired company to continue existing as a separate entity. Where a parent company holds more than 90 percent of both the capital and voting power in a subsidiary, a compulsory purchase of the remaining shares is possible. This is also the easiest form of merger from administrative and merger accounting perspectives. Merger accounting is generally complex in Sweden.

It is also possible, under the Companies Act, to carry out a demerger of a company.

A demerger can take place in two ways:

— A limited company is divided into two or more limited companies.

— Some of a limited company's assets are transferred to one or more other limited companies (partial demerger).

In the first situation, one limited company (the transferor) assigns all its assets and liabilities to two or more limited companies (the transferees), after which the transferor is dissolved without formal liquidation. The second situation implies that some of a transferor's assets and liabilities are assigned to one or several other limited companies without the transferor being dissolved.

Another important feature of Swedish company law concerns the ability to pay dividends. Distributions of profit may be made only out of a company's audited unrestricted equity. A formal decision is made at the annual general meeting (or an extraordinary general meeting) to distribute. Where all unrestricted equity has been distributed, the next dividend can first be made when the next year-end accounts have been audited. Hence, interim dividends are not possible.

Finally, a common issue on transaction structuring involves the provisions concerning financial assistance. Briefly, these

provisions make it illegal for a target company to give financial assistance, directly or indirectly, for the purpose of acquiring that company's shares.

Group relief/consolidation

Sweden does not have tax consolidation. However, the law allows for the transfer of profit within an affiliated Swedish group through group contributions. In a qualifying group contribution, the company making the contribution deducts the amount from its taxable income and the recipient company includes the contribution as taxable income for the same financial year.

A profit-making company can also make a group contribution to another profit-making company, thereby pooling taxable profits in one company.

Companies giving and receiving contributions must fully disclose the contributions in their tax returns for the same year. There is no requirement that the group contributions must be paid in cash; it is sufficient that the companies involved book the contribution in the accounts as a claim/receivable. However, it is important to recognize the transfer of value in the books.

The main condition for an allowable group contribution is that the parent holds more than 90 percent of the shares of the subsidiary for both the parent's and the subsidiary's entire financial year or since the subsidiary started to conduct business (qualifying period).

Transfer pricing

Where the acquisition is financed by intragroup debt, the interest should be set at arm's length. However, this should not apply between Swedish companies that can tax-consolidate. Failure to comply with the arm's length principle could result in transfer pricing adjustments in the relevant jurisdiction. However, where an adjustment is imposed on a company in one jurisdiction, the counterparty should normally be able to request a corresponding adjustment under the mutual agreement clause in a tax treaty or the EU Arbitration Convention, where applicable. Potential penalties (tax surcharge) might apply on the additional tax arising from an income adjustment.

On 22 December 2015, the Swedish Tax Agency declared that it considers the report Aligning Transfer Pricing Outcomes with Value Creation, prepared as part of the Organisation for Economic Co-operation and Development's Action Plan on Base Erosion and Profit Shifting (BEPS), to merely clarify the arm's length principle. The agency says the report's guidance will therefore have direct and retroactive effect on the interpretation of the arm's length principle in Sweden.

Some of the report's guidance may have implications for the transfer pricing aspects of cross-border mergers and acquisitions. In particular, funding activities undertaken by so-called 'low-functioning entities' (entities lacking the substance to control the financing risk) may be under scrutiny in the future. According to the BEPS report, these entities would be entitled to no more than a risk-free return on their funding activities.

Foreign investments of a local target company

A legal entity liable to tax in Sweden that holds, directly or indirectly, at least 25 percent of the capital or the voting rights in a foreign legal entity at the end of the taxable entity's financial year is subject to tax as a controlled foreign company (CFC), where the foreign legal entity is deemed low-taxed. The foreign legal entity is deemed low-taxed where its income is not taxed or is taxed at a tax rate below 12.1 percent. This tax rate is computed on the net income calculated using Swedish tax rules.

Legal entities resident in certain areas (countries) mentioned in a white list are deemed not to be CFCs. Those legal entities do not have to fulfill the criterion of being taxed at a rate of at least 12.1 percent. However, certain activities in some areas/countries are not covered by the white list, such as banking, financing, other financial activities and insurance. Any activities of this kind excluded from the white list in areas/countries within the EEA are excluded only where conducted intragroup.

Companies within the EEA, even where low-taxed, are excluded from the CFC rules where substance can be proven.

Comparison of asset and share purchases

Advantages of asset purchases

— The goodwill element in the purchase price can be depreciated or amortized for tax purposes.

— A step-up in the cost-base for capital gains tax purposes is obtained for certain fixed assets.

— No previous liabilities of the company are inherited.

— Possible to acquire only part of a business.

— Greater flexibility in funding options.

— Profitable operations can be absorbed by loss companies in the buyer's group, thereby effectively gaining the ability to use the losses.

Disadvantages of asset purchases

— Possible need to renegotiate various types of external agreements.

— A higher capital outlay is usually involved (unless debts of the business are also assumed).

— May be unattractive to the seller, especially where a share sale would be tax-exempt, thereby increasing the price.

— 4.25 percent transfer tax applies where real property is included (corporations).

— Benefit of any losses incurred by the target company remains with the seller.

Advantages of share purchases

— Likely more attractive to the seller, especially where a share sale would be tax-exempt. May benefit from tax losses of the target company (but there are many exceptions).

— May gain benefit of existing external contracts.

— No capital or transfer duties payable on net assets acquired (where the assets consist of real property).

Disadvantages of share purchases

— Liable for any claims or previous liabilities of the entity.

— No deduction for the goodwill element in the purchase price.

— Losses incurred by any companies in the buyer's group in years prior to the acquisition of the target can only be offset against any profits made by the target company after 5 years.

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Switzerland

Introduction

As part of ongoing globalization, Swiss enterprises are expanding significantly into foreign markets by setting up foreign entities or by M&A transactions. At the same time, foreign strategic and financial investors are increasing their M&A activities in Switzerland, focusing particularly on smaller quoted entities and larger non-quoted entities.

The Swiss tax system and Switzerland's extensive network of tax treaties offer attractive opportunities for M&A activities. This report addresses the Swiss tax aspects of typical deal structures in Switzerland, the choice of acquisition vehicle and tax-efficient financing arrangements.

Recent developments

The Federal Council released new draft legislation for the ongoing tax reform on 6 September 2017, after the public rejected the previous tax reform legislation in a vote in February 2017. The following aspects of the new tax reform may affect M&A activities:

— elimination of privileged Swiss tax regimes, including the holding company, mixed company, principal company and finance branch regimes

— introduction of step-up mechanisms for corporate tax purposes connected to the elimination of privileged tax regimes and the tax-neutral step-up and later amortization of hidden reserves on immigration into Switzerland

— introduction of new incentive rules for research and development activities

— introduction of other tax incentives, including a general reduction of corporate income tax rates at the cantonal/communal level, reduction of capital tax basis for certain assets (i.e. participations, intangible property) and introduction of a tax credit scheme for permanent establishments (PE) in Switzerland.

The draft legislation is still subject to change during the parliamentary approval process and would further be subject to a public vote in the case of a referendum. The new legislation is expected to enter into force in January 2019 or 2020.

Asset purchase or share purchase

Whether an acquisition takes place in the form of an asset or a share deal has different tax implications for both the seller and buyer. Buyers usually prefer asset deals to limit their risks from the acquired business and achieve a step-up in book value. Sellers often prefer share deals, which usually generate capital gains subject to privileged taxation.

Purchase of assets

Purchase price

The purchase price for the acquired business must be allocated to the net assets. Based on accounting regulations, the acquired net assets are reported at their fair market value and an excess amount is booked as goodwill.

If the acquired business includes participations, the allocation of the purchase price to participations and other assets has important tax implications for the seller and buyer, as outlined below. Thus, the allocation should be carefully analyzed and agreed on in the purchase agreement.

Goodwill

In case of the purchase price exceeding the fair market value of the net assets of the business acquired, the exceeding amount of the purchase price would be allocated to goodwill. In accordance with Swiss accounting rules, goodwill is depreciated at the level of the buyer. The depreciation allowed for tax purposes is usually either 40 percent per year for 5 years on a declining-balance basis (the remaining balance being considered in the last year) or 20 percent per year on a straight-line basis. This corresponds with the general accounting treatment of intangible property. Therefore, there is no disadvantage in allocating a part of the purchase price to goodwill. Given the high rate of depreciation, it may even be advantageous. If economically justified, it may be possible to accelerate the rate of depreciation.

Depreciation

Safe-haven depreciation rates published by the Swiss tax authorities generally follow Swiss accounting rules.

Tangible assets can be depreciated either on a straight-line or declining-balance basis. Once a depreciation method has been chosen, that method must be applied consistently, unless an amendment is economically justified. It is possible to use different methods for different assets and to apply extraordinary depreciations in certain situations (e.g. for participations).

The write-off of participations is generally tax-deductible, but the shareholder is required to revalue qualifying participations (shareholding with a share quote of at least 10 percent) up to the initial book value if the fair market value is going to increase.

Tax attributes

In case of an asset deal, the buyer cannot use the tax loss carried forward of the acquired business (except for reorganizations under the Merger Act, such as spin-offs and transfers of shares). At the level of the buyer, depreciation of the purchased assets reduces the income tax basis. Special cantonal/communal rules may apply on transfers of real estate (i.e. real estate gains tax).

Value added tax

Where assets are transferred, items that are within the scope of valued added tax (VAT) are subject to VAT at the standard rate of 7.7 percent or reduced rate of 2.5 percent. A notification procedure must be applied where assets are transferred between two parties that are registered for Swiss VAT purposes and the following conditions are met:

— the VAT liability would exceed 10,000 Swiss francs (CHF)

— the assets are transferred as part of an intercompany asset transfer

— the assets are transferred in a reorganization under the Merger Act or a tax-neutral reorganization.

In this case, no VAT needs to be paid, only declared, and the buyer assumes the VAT position of the seller. Where assets are transferred abroad, the applicable VAT rate is 0 percent.

Subject to the tax authorities' approval, the notification procedure may also be applied voluntarily, particularly where real estate is transferred or well-founded interest can be proven.

Transfer taxes

Securities transfer tax is payable on the transfer of any taxable securities (e.g. bonds, shares) where a registered securities dealer acts on its own account or as an intermediary in the transaction. According to Swiss stamp duty legislation, Swiss securities dealers also include companies not performing a banking-type function (i.e. Swiss companies whose assets include taxable securities with a book value higher than CHF10 million).

The rate of securities transfer tax is 0.15 percent on Swiss securities and 0.30 percent on non-Swiss securities.

Real estate transfer tax and notary fees may apply on the transfer of Swiss-located real estate and may differ among the 26 cantons.

Purchase of shares

The purchase price is fully attributed to the participations acquired. The book value of participations cannot be written off at the level of a Swiss acquisition company, unless the investment's fair market value decreases. A reduction in value is tax-deductible at the level of the Swiss buyer, whereas a subsequent increase in the fair market value triggers a taxable revaluation (clawback). Goodwill cannot be separately reported, neither in the balance sheet nor for tax purposes.

Sellers generally prefer a share deal because a Swiss corporate seller can usually benefit from a tax-exempt capital gain (provided that a share quota of at least 10 percent, which has been held for at least 1 year, is sold). Swiss individuals selling shares as private assets usually achieve a tax-exempt capital gain, subject to compliance with restrictions under the indirect partial liquidation rules (see next section). Individuals selling shares as business assets and selling qualifying shareholdings (share quota of at least 10 percent) may benefit from a privileged taxation.

Indirect partial liquidation

Individuals selling their shares as private assets generally benefit from fully tax-exempt capital gain, whereas dividend income is subject to income tax. In order to avoid abusive transaction schemes, the practice of the so-called 'indirect partial liquidation' is assumed if the following conditions are met:

— a Swiss-resident individual sells privately held shares to a company or an individual who is going to hold the acquired shares as business assets

— at least 20 percent of the share capital (single shareholder or collectively) is transferred

— non-business-related assets are available in the target (consolidated approach)

— distributable reserves are available in the target (from a commercial law point of view)

— dividends are distributed within a 5-year period after signing

— there is a certain cooperation between the seller and the buyer.

If these conditions are met, the tax-exempt capital gain of the seller is reclassified into a taxable dividend in the amount of the lower of the capital gain or distributed reserves linked

to non-business-related assets. Therefore, sellers usually request the insertion of an appropriate indemnity clause in the share-purchase agreement to restrict the buyer from distributions that might trigger such a reclassification.

Loans or guarantees granted by the target company in connection with the acquisition do not qualify as direct or indirect distributions, provided the financial arrangements comply with the arm's length principle and do not result in a write-off of receivables.

Post-acquisition reorganizations, such as a merger between the target company and acquisition vehicle, generally qualify as direct or indirect distributions and trigger an indirect partial liquidation. The distribution of future profits does not qualify as an indirect partial liquidation.

Tax indemnities and warranties

In the case of a share deal, tax liabilities and tax risks remain with the Swiss target company. Thus, a tax due diligence is highly recommended to assess potential exposures. The buyer usually claims contractual tax indemnities and warranties from the seller to shift the target company's tax exposures of pre-closing periods to the seller. Such indemnities are essential for non-quantifiable tax risks arising in case of tax audits.

Tax losses

Tax losses can be carried forward for a period of 7 years but are usually not approved by the tax authorities until the date of use. With the exception of special cases, such as the transfer of shares in an inactive company, Swiss law does not restrict the use of tax loss carried forward in a target company after a change of ownership.

Crystallization of tax charges

As stated earlier, tax liabilities and tax risks remain with the Swiss target company and crystallize at this company's level.

For the withholding tax (WHT) on dividends, the buyer needs to consider the so-called 'old reserves' theory of the Swiss tax authorities. This practice applies to distributable reserves subject to a non-refundable WHT on dividends. If, due to a change in ownership, the non-refundable WHT is reduced to a more beneficial rate than before the transaction, the Swiss tax authorities may argue that distributable reserves remain subject to the higher non-refundable WHT rate, irrespective of the future shareholder or tax treaty applicable. Distributable reserves qualify as 'old reserve' to the extent that non-business relevant assets are available at the time of the change in ownership.

There is also a risk that the Swiss tax authorities may argue that the old reserves rule also applies to the deemed liquidation proceeds on a formal liquidation, 'partial liquidation' or post-acquisition merger (so-called 'liquidation by proxy' rule). In this case, the Swiss tax authorities may argue that the buyer did not intend to buy and keep the target but to liquidate it on the sellers' behalf to avoid the WHT on liquidation for these shareholders. As a common example, the liquidation by proxy rule would apply to an acquisition of a real estate company followed by a post-acquisition merger.

Pre-sale dividend

A Swiss seller usually does not wish to pay out pre-sale dividends. However, a buyer can request such dividends to mitigate its WHT exposure under the old reserves theory or if the seller imposes post-closing restrictions under the indirect partial liquidation rules on the buyer (see 'Indirect partial liquidation' above).

A dividend can only be distributed on the basis of (audited) annual accounts not more than 6 months old. Thus, a later dividend distribution of retained earnings may require an (audited) interim balance sheet. Interim dividends (i.e. dividends from current-year earnings) cannot be paid out under Swiss corporate law.

Value added tax

The sale of shares is generally not subject to Swiss VAT. However, it should be possible recover input taxes on the acquisition costs, because such costs are commercially justified and the Swiss acquiring entity is the beneficiary of the underlying services.

Transfer taxes

Where the seller, buyer or intermediary of a share transaction qualifies as a securities dealer (e.g. a bank or Swiss company with more than CHF10 million in shares or securities reported as asset in the statutory balance sheet), a securities transfer tax applies of 0.15 percent on domestic shares and 0.3 percent on foreign shares. Exceptions may apply if the shares are transferred as part of an intercompany restructuring (e.g. merger, spin-off or intercompany transfer of qualifying shares).

Tax clearances

Advanced tax rulings are possible and common in Switzerland. They can usually be obtained within 4 to 6 weeks.

Rulings concerning income and capital taxes must be submitted to the cantonal tax authorities. Rulings concerning VAT, stamp duties, securities transfer taxes and WHT must be submitted to the Swiss tax authorities. Rulings that the buyer wishes to submit pre-closing for the Swiss target company usually require authorization by the target company and seller.

Choice of acquisition vehicle

The acquisition of a Swiss business or Swiss target company should be carefully structured because the choice of acquisition vehicle has a significant impact on the overall tax rate.

Local holding company

Dividend income from 'qualifying participations' benefits from a participation deduction scheme. Qualifying participations are participations having a share quota of at least 10 percent or a fair market value of at least CHF1 million. This scheme reduces the income tax in the proportion of the net revenue from qualifying participations to the company's net profit. The 'net revenue' from qualifying participations is defined as the gross revenue less proportionate financial expenses and a lump-sum deduction of 5 percent for administration expenses. The participation income is virtually tax-exempt as a result.

Due to the absence of group taxation in Switzerland (except for VAT), a Swiss target company does not necessarily need to be acquired by a Swiss acquisition vehicle. However, a Swiss buyer may benefit from a preferential tax regime or enable a tax-neutral merger with the target company (e.g. if required by the financing banks).

Under Swiss tax law, a 'holding company' is defined as a company that conducts no business activity in Switzerland but simply holds and manages participations. Provided at least two-thirds of the company's assets are represented by participations and/or earnings from participations, such holding company may benefit from a privileged taxation of generally 7.8 percent corporate income tax, achieved by an income tax exemption at the cantonal and communal level, and ordinary taxation at the federal level.

Note that the taxation regime for holding companies will likely be abolished in the course of the ongoing tax reform (see previous section).

For corporate shareholders, a depreciation of shares due to a lower fair market value is tax-deductible, but the shareholder is required to revalue qualifying participations for tax purposes up to the initial book value if the fair market value increases in the future.

Interest expenses borne in connection with the funding of the acquisition can be offset against taxable income. Where taxable income is insufficient, the expenses increase the holding company's tax losses carried forward. Pushing debt down by merging the acquisition vehicle with the target company is unlikely to be accepted by the Swiss tax authorities for anti-abuse reasons.

According to a current practice, a debt pushdown can usually only be achieved for strategic buyers or by careful structuring.

Foreign parent company

An acquisition by a foreign parent company should take into account existing tax treaties or the application of bilateral agreements in order to benefit from a reduced or zero WHT on dividends.

In 2005, Switzerland introduced the reduction-at-source concept for qualifying dividend payments to treaty-entitled foreign parent companies. The reduction is obtained by filing an advance application with the Swiss tax authorities, which is valid for 3 years. The Swiss tax authorities reviews the treaty entitlement of the foreign shareholder, focusing on substance and beneficial ownership. An advanced ruling stating the facts for the shareholder's entitlement is therefore generally recommended.

On approval of the application, only the net applicable treaty tax rate is payable (i.e. the refundable 35 percent WHT does not need to be paid and refunded). In any case, all relevant WHT declaration forms need to be filed to the tax authorities within 30 days after the due date of the dividend distribution. If the forms are filed late, the Swiss tax authorities may still grant a reduction at source, subject to a late filing penalty.

In addition to tax treaties, similar rules to those in the European Union (EU) Parent-Subsidiary and Interest and Royalties Directives became applicable to Swiss companies in 2005 (Swiss-European Taxation of Savings Treaty). With the entry into force of the automatic exchange of information (AEOI) in Switzerland on 1 January 2017, the Swiss-European Taxation for Savings Treaty has been replaced by the agreement on the AEOI on tax matters between Switzerland and the EU. Accordingly, dividend payments to EU-domiciled parent companies on direct shareholdings of at least 25 percent held for at least 2 years still benefit from a full reduction of withholding at source (i.e. WHT rate of 0 percent). The same applies to certain intragroup interest payments and royalties.

Irrespective of any treaty, a foreign shareholder selling its Swiss subsidiary is not subject to Swiss income tax based on domestic law (exceptions for real estate companies may apply).

Non-resident intermediate holding company

The comments earlier in this report on a foreign parent company also apply for non-resident intermediate holding companies. The holding company needs to meet the requirements of the Swiss tax authorities in terms of substance and beneficial ownership in order to benefit from a tax treaty or from the AEOI agreement (see earlier in this report).

Local branch

A foreign corporation acting as the head office of a Swiss branch is subject to Swiss income and capital tax with respect to income and net assets allocated to the branch.

The acquisition of a target company by a Swiss branch should be carefully structured because participations are usually considered to be allocated to the head office for tax purposes.

Swiss branches are taxed in the same way as companies, so they can qualify for the holding company privilege (see prior section). For dividend distributions from a Swiss target company, the tax treaty between Switzerland and the country of the foreign head office usually applies, but this needs to be reviewed case-by-case.

Joint venture

The taxation of joint ventures depends on their legal form, whether they are corporations (see earlier comments on holding companies) or partnerships, which are usually considered as being transparent for tax purposes. In the latter case, the tax residency and legal form of the partners determine the tax implications. Usually, a joint venture in the form of a separate corporate entity is preferred because the joint venture partners' liability is limited and the allocation of profits and application of tax treaties are less complex.

Choice of acquisition funding

The funding of the acquisition with debt, equity or hybrid instruments must be considered from a Swiss tax perspective to achieve a tax-efficient funding structure.

Debt

No stamp duty is levied on the issue and transfer of bonds (including cash bonds and money market instruments).

In general, interest on ordinary loans is not subject to WHT. However, WHT of 35 percent is levied on interest due on bonds and other collective fundraising schemes as listed below, whereas a refund applies in accordance with Swiss domestic tax law or tax treaty, if applicable:

— A loan qualifies as a collective fundraising scheme ('bond') where the aggregate number of non-bank lenders (including sub-participations) to a Swiss company under a facility agreement exceeds 10 (under equal conditions) or 20 (under variable conditions), and the total amount of such debt exceeds CHF500,000.

— Debt without fixed maturity date (e.g. cash pooling) is usually not relevant for a Swiss company as debtor (i.e. the company does not qualify as a bank for Swiss tax purposes), where the aggregate number of its non-bank lenders does not exceed 100 and the total amount of such debt does not exceed CHF5 million.

In general, third-party funding arrangements of foreign group companies are not subject to Swiss WHT. However, where the tax authorities consider such funding arrangements to be a collective fundraising scheme for Swiss tax purposes, interest charges would be subject to Swiss WHT. Among others, this treatment applies where the foreign company borrows the funds and:

— the foreign company is a subsidiary of a Swiss company

— the Swiss parent company is the guarantor

— the funds are lent onwards to a Swiss company.

The funding arrangement needs to be assessed case-by-case.

As interest on private and intercompany loans is generally not subject to WHT, taxpayers should ensure that they do not exceed the above thresholds and that they comply with Swiss anti-abuse rules.

Deductibility of interest

Arm's length interest is generally tax-deductible. However, deduction of interest paid to affiliates may be subject to limitations. The Swiss tax authorities publish annual guidelines on the interest rates considered appropriate on CHF and foreign currency borrowings (safe haven minimum and maximum interest rates).

The Swiss tax authorities have also issued thin capitalization guidelines (safe haven rules), which define the level of related-party debt generally accepted from a Swiss tax perspective.

Based on these guidelines, Swiss companies can leverage the acquisition of assets up to the following debt-asset ratios:

Asset (valued at fair market value)	Percent
Cash	100
Receivables	85
Inventory	85
Other current assets	85
Swiss or foreign-issued bonds in CHF	90
Foreign-issued bonds in foreign currency	80
Listed Swiss or foreign shares	60
Other shares	50
Participations	70
Loans	85
Fixed assets	50
Real estate for manufacturing purposes	70
Intangible assets	70

Source: KPMG in Switzerland, 2018

For finance companies, the safe haven debt ratio is usually 6/7 of total assets (finance branch: 10/11). As mentioned earlier, these guidelines are only safe haven rules. The company can diverge from them, provided it can prove that the financing structure within its business complies with arm's length terms.

Non-compliance with the thin capitalization rules that cannot be commercially justified results in a reclassification of part of the related-party debt into equity (subject to capital tax) and of interest being qualified as a non-tax-deductible deemed dividend subject to Swiss WHT. Debt from third parties is outside the scope of the thin capitalization rules, but third-party debt secured by related parties qualifies as related-party debt for thin capitalization purposes.

Withholding tax on debt and methods to reduce or eliminate it

Arm's length interest on loans is not generally subject to WHT. For funding arrangements qualifying as bonds, collective fundraising schemes or downstream guarantees, WHT of 35 percent is levied at source (i.e. Swiss-resident borrower).

In an international context, WHT may be refunded or credited in accordance with any applicable tax treaty or AEOI agreement.

Checklist for debt funding

— Does the debt qualify as third-party debt (no related-party guarantees)?

— Are the safe haven interest rates for intercompany financing met?

— Are the thin capitalization rules complied with, or is a third-party test available?

— Does the debt qualify as a collective fundraising scheme ('bond') or the borrower as a bank for Swiss tax purposes?

— Does a Swiss parent company grant a guarantee to a fundraising foreign subsidiary with funds being used in Switzerland?

Equity

Some equity financing may be required to meet debt-to-equity requirements of financing banks or to strengthen the equity position of the acquiring company.

Stamp duty at the rate of 1 percent is payable on the issue of shares, whereas a one-time exemption applies on CHF1 million. Other contributions of direct shareholders as well as a capital surplus are also subject to stamp duty. Exemptions may apply to restructurings.

Dividends are generally subject to a WHT of 35 percent. Refunds or reductions of the applicable WHT rate may be available under a tax treaty or the AEOI agreement. Dividends from a shareholding of at least 20 percent from a Swiss company to a Swiss corporate shareholder can be distributed without WHT by applying the Swiss domestic notification procedure.

Under the capital contribution principle, the repayment of reserves derived from qualifying equity contributions made by direct shareholders (e.g. capital surplus, contributions) can be distributed without being subject to WHT and without being subject to income tax for Swiss individuals holding the shares as private assets.

Reorganizations

Transactions and reorganizations are generally tax-neutral if the net assets remain subject to taxation in Switzerland, the tax book values remain unchanged and the transferred business is a going concern or business unit.

Statutory merger

The Merger Act provides for two kinds of statutory mergers:

— *Merger by absorption*: Assets and liabilities are transferred to the surviving company in exchange for newly issued shares. The shares in the absorbed company are then cancelled, and the company is dissolved.

— *Merger by combination*: A third company is formed specifically for the absorption of two or more companies. The shareholders of the combined companies receive shares in the new company in exchange for their shares in the combined companies.

Mergers are generally income tax-neutral (i.e. hidden reserves should be transferable without taxation) where the following conditions are met:

— Assets and liabilities are transferred at tax book value (thus, a step-up in basis without income tax consequences is not possible).

— Net assets remain subject to Swiss income taxation. This requirement is met even if after the merger the net assets are allocated to a PE in Switzerland.

In general, the absorbing company takes over the tax attributes of the absorbed company. Any tax loss carried forward of the absorbed company can be used by the absorbing company, unless the transaction is qualified as a tax avoidance scheme.

The merger should not trigger any WHT consequences where reserves and retained earnings of the merged entity are transferred and remain subject to Swiss WHT in case of a distribution.

A share capital increase in the context of a qualifying reorganization (merger) usually is not subject to stamp duty. In addition, the transfer of securities (e.g. shares) is usually exempt from securities transfer tax, if applicable.

Where the surviving entity of a merger uses treasury shares, which were previously repurchased from shareholders, to compensate the shareholders of the absorbed company, any gain is considered taxable income of the absorbing company. For private Swiss shareholders receiving such shares, the difference between nominal value (and proportionate capital

contributions, if available) and fair market value is subject to income tax. Hence, a private individual shareholder may suffer tax consequences without being aware of the exposure beforehand and without receiving any additional cash. Foreign corporate and private individual shareholders receiving new shares may be subject to non-refundable Swiss WHT. Contractual hold-harmless clauses are recommended.

Cash considerations to private individual shareholders are subject to WHT and subject to income tax at the shareholders' level.

Cross-border mergers

The Swiss Code on Private International law (CPIL) includes provisions governing registered office transfers to and from a foreign country, as well as provisions to cover cross-border mergers, demergers and transfers of assets. In contrast to purely domestic mergers and immigration through cross-border mergers, the requirements for emigration mergers include pre-transaction safeguards to protect creditors (art. 163b par. 3 CPIL). The provisions apply correspondingly to demergers and transfers of assets involving Swiss and foreign companies.

Other provisions relate to the place for debt collection and jurisdiction in connection with cross-border transactions and to the recognition of registered office transfers, mergers, demergers and transfers of assets carried out in foreign jurisdictions.

Immigration merger

Basically, the same tax principles apply as for a domestic merger. However, from a legal perspective, foreign legislation needs to allow an immigration merger.

Emigration merger

Where a Swiss business is transferred outside Switzerland, significant tax consequences may arise. Qualifying for Swiss tax purposes as a deemed liquidation, an emigration merger triggers the same tax consequences as a statutory liquidation (i.e. hidden reserves are subject to income taxes and any deemed liquidation proceeds are subject to WHT). To the extent that net assets are allocated to a Swiss PE of the foreign absorbing company, the emigration merger does not trigger income tax consequences. With regard to the WHT liability, a refund or reduction of the WHT rate may apply, depending on the domicile of the shareholders of the absorbed Swiss company and, in an international context, the applicable tax treaty or AEOI agreement.

Share-for-share transactions involving Swiss target company and/or Swiss investors (quasi-merger)

In exchange for their shares, the shareholders of the contributed company are compensated with shares in the receiving company. The acquired target company continues to exist as a subsidiary of the acquiring company. Share-for-share transactions are in principle tax-neutral.

They are often a more flexible alternative than statutory mergers because, for example, risks and liabilities of the target company are kept isolated and the administrative and operational burden may be lower than in case of a cross-border merger transaction.

Private individual shareholders of target companies may prefer a share-for-share deal anyway. Cash consideration of up to 50 percent of the transaction value is permissible and, in principle, is tax-free for a Swiss private individual shareholder. Cash consideration by merged entities in a statutory merger generally qualifies as taxable income and is subject to WHT.

The less favorable tax consequences of a statutory merger cannot be avoided by structuring the transaction as a share-for-share deal with subsequent absorption of the target company. Based on the substance-over-form rule, such transaction would qualify as a statutory merger if the absorption occurs within a 5-year period. Swiss private individual shareholders who might be facing taxable income on a subsequent merger are likely to insist on hold-harmless clauses in transaction agreements.

Demerger

The Merger Act stipulates that corporations and associations can either split up or spin off parts of their business.

— In a split-up, the transferring entity is dissolved after the transfer and shareholders receive shares of the entities that take over the business.

— In a spin-off, the transferring entity continues operations after the transfer and shareholders receive shares of the entities that take over the business.

Demergers are generally income tax-neutral. Any hidden reserves should transfer tax-free if the following conditions are met:

— Assets and liabilities are transferred at tax book value (thus, a step-up in basis without income tax consequences is not possible).

— Net assets remain subject to Swiss income taxation. This requirement is met even if the net assets are allocated after the demerger to a PE in Switzerland.

— Separated entities to operate own business after the reorganization.

Neither the assets transferred nor the shares in the transferee entity are subject to a blocking period. Thus, investors can immediately dispose of business units that are not in line with their strategic plans or need to be transferred for anti-trust reasons. Additionally, in principle, the business of a target

company can be restructured tax neutrally in order to meet the market's expectations.

However, the requirement of continuing businesses at the level of the separated entities is generally subject to close scrutiny by the tax authorities. For pure holding companies, the term 'business' implies that the participations held are qualifying participations in active companies and that the holding companies perform true group management functions with appropriate personnel. Finance and intellectual property companies qualify as businesses if they conduct transactions with third parties or affiliated entities and have at least one full-time employee engaged in the operations. For non-operating entities, a demerger might prove difficult due to the stringent requirements on the business criteria. Other means of transfer may be preferable, such as the transfer of assets (discussed later). If a group with mixed business entities is to be divided into two or more separate groups, the demerger of the common holding and intellectual property entities requires special attention.

The demerger should not trigger any WHT consequences if reserves and retained earnings of the transferring entity are transferred and remain subject to Swiss WHT in the case of a distribution.

If reserves and retained earnings are converted into share capital or capital contribution reserves, WHT is due and Swiss private individual shareholders realize taxable income. Whether, and to what extent, a refund of the WHT (35 percent) is available must be analyzed case-by-case.

A share capital increase in the context of a qualifying reorganization (demerger) may not be subject to stamp duty. In addition, the transfer of securities (e.g. shares) is usually exempt from securities transfer tax, if applicable.

Intragroup transfer of assets

In principle, the intragroup transfer of qualifying participations (i.e. share quota of at least 20 percent), businesses or parts of businesses, and business assets at tax book value is tax-neutral. The tax-neutrality of the transfer of such assets is subject to a 5-year blocking period applying to the assets transferred and the common control of the Swiss legal entities involved (e.g. if the Swiss transferor and transferee have a common parent company).

In complex group structures, the ownership of the participation needs to be closely monitored to satisfy these requirements. If a blocking period is breached, the Swiss entities under common management at that time are jointly and severally liable for taxes due.

In practice, the blocking period is mainly relevant for transfers of individual assets, such as real estate or intellectual property. The transfer of businesses should qualify under the demerger rules, so no blocking period applies.

If the transferee breaches the blocking period, hidden reserves are taxed at the level of the transferor entity and a dividend is deemed to be paid. The deemed dividend is subject to WHT, which is levied at source at the level of the transferring company and may not be fully recoverable by beneficiaries.

Asset drop-down

The contribution or sale at tax book value of businesses, business units, fixed assets or qualifying participations (i.e. share quota of at least 20 percent) by a company to a subsidiary that is subject to Swiss taxation is tax-neutral. Except for the transfer of qualifying participations, the drop-down of assets is subject to a 5-year blocking period. The blocking period applies to both the transferred assets and the shares held by the transferring entity in the subsidiary.

Hybrids

Debt is usually only reclassified as equity if thin capitalization is an issue. In other circumstances, instruments having the form of debt are accepted as such and follow Swiss accounting principles.

As a rule, hybrid financial instruments can be characterized as follows:

Redeemable preference shares	Share capital
Convertible loan notes	Debt
Perpetual debt	Debt
Index-linked debt	Debt
Profit participation loan	Debt

Source: KPMG in Switzerland, 2018

Regarding income derived from hybrid instruments, the Swiss participation deduction and privileged taxation of dividend do not apply to (dividend) income treated as tax-deductible by the payer.

Discounted securities

An acquisition of securities at a discount generally results in a taxable gain if the full value of the security is realized. The tax treatment generally follows accounting rules, but this should be reviewed case-by-case.

Deferred settlement

A deferred settlement of interest generally does not affect the deduction of the interest for tax purposes when the interest is booked.

Deferred settlements of the purchase price can be structured through a seller loan or earn-out rules. For seller loans, the

comments on debt financing apply. Earn-out elements generally should be treated as part of the capital gain for the seller and subsequent acquisition costs for the buyer. Depending on the circumstances, it may be advisable to gain certainty on the tax treatment with an advance ruling.

Other considerations

Concerns of the seller

As mentioned, a Swiss-resident seller (corporation or individual holding the shares as private assets) usually prefers a share deal to benefit from a privileged taxation of capital gain.

A seller with tax losses close to forfeiture may be willing to agree to an asset deal. However, sellers usually prefer a share deal because the historical tax risks remain with the entity to be sold.

Company law and accounting

The Swiss Code of Obligations (CO) covers a number of business entities in Switzerland. In structuring a transaction, the parties involved must decide which type of entity best suits their needs. Tax issues may play an important part in these decisions.

Corporation — *Aktiengesellschaft* (AG)

The corporation corresponds to the American corporation and is the most widespread form of association in Switzerland. It is also considered best-suited for the requirements of foreign business interests. It is preferred for its ease of incorporation and the limited liability. Its main features are:

— formation according to the CO

— liability limited to share capital

— formed by issue of bearer or registered shares

— minimum share capital of CHF100,000

— restrictions on the acquisition of own shares.

Limited liability company — *Gesellschaft mit beschränkter Haftung* (GmbH)

The limited liability company (LLC) is a hybrid of a corporation and a partnership that is becoming more widespread in Switzerland. For Swiss tax purposes, the LLC qualifies as a corporation. Its main features are:

— formation procedure similar to a corporation, according to CO

— owners have limited legal liability

— owners may participate in the management of the company

— minimum share capital of CHF20,000.

Other, non-corporate forms of business entities admitted by the CO are as follows:

Partnership — *Kollektivgesellschaft*

The main features of partnerships are:

— partners must be individuals

— no legal personality

— partners have unlimited liability

— transparent for tax purposes.

Limited partnership — *Kommanditgesellschaft*

The main features of limited partnerships are:

— partners with unlimited liability must be individuals

— partners with limited liability can be individuals or corporations, among others

— transparent for tax purposes.

Simple association — *Einfache Gesellschaft*

The main features of simple associations are:

— registration in the commercial register is not possible

— contractual arrangement in the nature of a joint venture

— corporations and individuals can be members

— transparent for tax purposes.

Corporate reorganizations, such as spin-offs, mergers, business transfers, and, in principle, cross-border mergers, are possible under the Merger Act of 2004. Most of these restructurings can be implemented tax-neutrally.

Swiss entities must follow the Swiss accounting rules, which are also relevant for tax purposes.

Group relief/consolidation

Apart from VAT, the concept of a consolidated or group tax return is unknown in Swiss tax law. Accordingly, each corporation is treated as a separate taxpayer and files tax returns on its own.

Under Swiss company law, consolidated financial statements are required for companies under common control, by majority vote or by another method.

The company is exempt from the duty to prepare consolidated statements if, together with its subsidiaries, it does not exceed two of the following thresholds in any 2 successive fiscal years:

— a balance sheet total of CHF20 million

— revenues of CHF40 million

— an average annual number of employees of 250.

However, consolidated statements must be prepared for the purpose of assessing as reliably as possible the company's financial position where:

— The company has outstanding bond issues.

— The company's shares are listed on a stock exchange.

— Shareholders representing at least 10 percent of the share capital request a consolidated statement.

Consolidated financial statements of non-listed companies are not publically available.

Transfer pricing

Today, most countries have adopted their own national transfer pricing regulations and documentation rules. Although national transfer pricing regulations can differ in detail, they are usually based on the 'arm's length principle', as defined by the Organisation for Economic Co-operation and Development (OECD) transfer pricing guidelines and in Article 9 of the OECD model tax treaty.

Switzerland is a member of the OECD and has accepted the OECD guidelines without reservation. On 4 March 1997, the Swiss tax authorities issued a circular letter instructing the cantonal tax authorities to adhere to the OECD guidelines when assessing multinational companies.

Swiss tax law does not contain specific documentation requirements. However, the taxpayer is obliged to provide the tax authorities with the necessary information regarding its own tax position as part of its normal obligation to cooperate. In this regard, Swiss tax authorities can request information on transfer pricing. Generally, OECD-compliant transfer pricing documentation is recommended and should be accepted by the Swiss tax authorities.

Although Switzerland does not have specific transfer pricing penalties, general tax penalties can be assessed in severe cases of non-arm's length arrangements, ultimately assessed as abusive or even fraudulent. In such cases, taxpayers are advised to provide full disclosure of all available information to counter the assessment and avoid penalization.

Dual residency

Companies are subject to Swiss income tax if their statutory seat or actual management is in Switzerland. Thus, companies whose statutory seat is outside of Switzerland but whose day-to-day business is managed in Switzerland qualify as Swiss-tax resident.

Special rules apply to residency for Swiss stamp duty and WHT purposes. Transaction planning needs to reflect these taxes and, in particular, the provisions of an applicable tax treaty.

Foreign investments of a local target company

Switzerland has no formal controlled foreign company (CFC) rules and applies the participation deduction on dividends irrespective of any minimum taxation requirements. The participation deduction regime (see 'Local holding company') also applies to capital gains on the sale of qualifying participations held for a minimum of 1 year. Income associated with foreign PEs is tax-exempt under domestic law. Tax losses from foreign PEs are provisionally allocated to the Swiss headquarters and recaptured to the extent the PE makes profits within a 7-year period.

Comparison of asset and share purchases

Advantages of asset purchases

— The purchase price (or a proportion) can be depreciated or amortized for tax purposes.

— A step-up in the cost base for capital gains tax purposes is obtained.

— Generally, no inheritance of historical tax liabilities (except for VAT, social security, employee WHT or in case of reorganizations).

— No deferred tax liabilities on retained earnings.

— Possible to acquire only part of a business.

— Interest expenses for the acquisition generally can be set-off against taxable income of the acquired business.

— Profitable operations can be acquired by loss-making companies in the buyer's group, thereby gaining the ability to use the losses.

Disadvantages of asset purchases

— Possible need to renegotiate supply, employment and technology agreements, and change stationery.

— From a legal point of view, the transaction involves more work and set-up of individual acquisition entities for a cross-border transaction.

— May be unattractive to the seller due to a taxable gain, which may increase the price.

— Higher transfer duties (e.g. on real estate and securities).

— Benefit of any losses incurred by the target company remains with the seller.

Advantages of share purchases

- Likely to be more attractive to the seller, so the price is likely to be lower (if the seller is a private individual or corporation).
- May benefit from tax losses of the target company (set-off against subsequent profits of target for a limited period).
- May benefit from existing supply or technology contracts and tax rulings for the target company.
- No real estate transfer tax (except for acquisitions of real estate companies).

Disadvantages of share purchases

- Deferred tax liability on difference between market and tax book value of assets.
- Risks and previous liabilities remain with the acquired entity.
- No deduction for the purchase price (no tax-effective depreciation of goodwill).
- Acquisition of tax liabilities on retained earnings that are ultimately distributed to shareholders.
- Debt for acquisition cannot generally be pushed down to the operating company.

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Ukraine

Introduction

The Ukrainian tax environment is characterized by numerous tax filing requirements and frequent tax payments. Corporate and personal tax rates have been moderate for a long time, and so are social security rates, as of January 2017, as discussed later in this report. Tax laws are often ambiguous and subject to numerous interpretations and frequent changes.

Although Ukraine remains a document-driven jurisdiction where legal form still prevails over the economic substance of transactions, courts are starting to pay more attention to economic substance when considering tax disputes. Among other things, courts have developed and apply a valid business purpose test and certain other legal doctrines and principles to deny tax benefits derived from abusive tax-driven transactions. Tax practice is often limited or inconsistent, giving rise to numerous disputes with the tax authorities. The local courts often do not have sufficient experience to consider complex tax disputes and can be biased against business in favor of the tax authorities.

These factors combine to complicate tax planning, related business decisions and tax due diligence of local businesses.

These factors also produce more tax risks in Ukraine, which are more significant than those typically found in jurisdictions with more mature and stable taxation systems. To some extent, the risks are mitigated by the tax authorities' usual entitlement to only assess additional tax liabilities within 3 years after the filing of the relevant tax returns, although a 7-year statute of limitations is prescribed for transfer pricing assessments.

Following a major tax reform in 2010, the government focused on enhancing the taxation system, fixing various controversies and ambiguities in new tax rules, and granting tax incentives to various industries.

Ukraine's rating in the World Bank's Doing Business[1] survey has greatly improved, due in part to measures to consolidate four social security and pension charges into one unified social contribution, eliminate and consolidate other small taxes, promote wider use of electronic tax filing, and strengthen minority investors' interests. Overall, Ukraine's rating climbed from 181st place in 2012 to 76th place in 2017.

Although the Ukrainian tax system is moving in the right direction by reducing the number of taxes, keeping the tax rates moderate and improving tax filing and administration procedures, more efforts and reforms are needed to overcome longstanding difficulties in administering taxes and reducing the number of tax audits and disputes.

Regarding the Ukrainian environment for mergers and acquisitions (M&A), high-profile acquisitions of Ukrainian businesses are usually structured as share deals by means of acquiring shares in foreign holding companies that hold shares in Ukrainian businesses. Asset deals and non-monetary acquisitions (including share-for-share exchanges) are relatively rare.

These and other important tax aspects of M&A transactions in Ukraine are discussed later in this report.

Income tax

Ukraine's corporate income tax rate is 18 percent.

Special taxation regimes are prescribed for insurance companies and eligible agricultural producers.

Failure of the Ukrainian tax authorities to properly administer collection and refunds of advance income tax payments (installments) prompted the parliament to cancel the monthly income tax installments and annual income tax filings and replace them with quarterly income tax filings and payments,

[1] "Doing Business 2018: Reforming to Create Jobs", World Bank Group, 2018.

as of January 2016. But small and medium-size businesses that have annual revenues of up to 20 million Ukrainian hryvnia (UAH; about 753,700 US dollars — US$) can still file corporate income tax returns and pay corporate income tax annually.

The taxable income or loss is primarily based on and aligned with the accounting income or loss, and there are limited prescribed adjustments to the accounting income or loss to determine the taxable income or loss. The key tax adjustments involve tax loss carry forwards, thin capitalization limitations, depreciation, reserves and transfer pricing. Transactions with securities are subject to special income tax rules.

Value added tax

The general value added tax (VAT) rate is 20 percent. A 7 percent VAT rate applies to imports and domestic supplies of certain medicines and medical devices (equipment), and exports of goods and certain services are zero rated.

In an attempt to prevent VAT fraud and improve VAT refund practices, the Ukrainian government introduced electronic administration of VAT in 2015. Even though the new VAT administration mechanism helped tackle the Ukraine's VAT challenges to a large extent, this mechanism should be further improved to ensure that honest VAT payers are not facing additional financing costs and administration inefficiencies as a result of the new electronic VAT administration system.

Unified social contribution

The unified social contribution (USC) underwent significant change, as of 1 January 2016. Specifically, the rate for employers, which previously varied from 36.76 to 49.7 percent, depending on the class of professional risk prescribed for the relevant business, was reduced to 22 percent. The 3.6 percent USC rate for employees was cancelled. The USC does not apply to the portion of monthly wages and salaries that exceed the prescribed threshold (about US$2,100, as of 1 January 2018).

Beneficial ownership concept

The 'beneficial ownership' concept was introduced in the Tax Code in 2011. This tax concept primarily applies to payments of interest, dividends and royalties paid by Ukrainian taxpayers to non-residents of Ukraine. Currently, to enjoy tax treaty benefits, an eligible foreign income recipient must be both:

— a tax resident in a jurisdiction with which Ukraine has an effective tax treaty, and

— the beneficial owner of the Ukrainian-sourced income.

The tax authorities are actively applying the beneficial ownership concept to deny tax treaty benefits in the context of cross-border intellectual property (IP) sublicensing or subleasing structures, and financing arrangements where a foreign recipient of Ukraine-sourced income is viewed by the Ukrainian tax authorities as a financial intermediary.

As the beneficial ownership requirement is now part of the domestic taxation system, the Ukrainian tax authorities actively apply the beneficial ownership concept even where the relevant tax treaty does not include this special anti-avoidance rule.

Asset purchase or share purchase

Generally, an acquisition of a business can be structured by means of purchasing equity in, or assets of, a selected business or by means of business combination (reorganization). Acquisitions of shares or business assets are the most common forms of purchasing business in Ukraine.

There are many fundamental tax and legal differences between these two options. In practice, the choice between the asset and share deal depends on the findings of the due diligence assignment, pricing parameters, negotiations between the parties, timing, tax and legal considerations pertaining to each structuring alternative and other important factors.

Both share and asset deals can involve significant costs associated with financing, documenting and implementing the acquisition.

Generally, sellers usually prefer to sell shares while buyers usually prefer to acquire assets.

Asset deals tend to be more time-consuming and expensive than share deals as there are needs, for example, to assign or renegotiate contracts, transfer employees, re-register legal title in land, real estate and certain other assets, and receive new licenses and permits. For regulated businesses (e.g. banking, insurance and telecommunications), an asset deal may not be feasible due to difficulties in obtaining the relevant license for a new entity.

Certain licenses and permits are not available to foreign companies or their branches in Ukraine. There could also be legal restrictions for foreign persons to directly own (control) Ukrainian businesses that are engaged in certain businesses or to own certain assets (e.g. land). Overall, share deals cause less disruption to the business as the target business typically continues to operate as it did before the acquisition.

Due to the specifics of the local tax and legal environment, share deals are more common in Ukraine. It is also typical for the Ukrainian M&A market to structure the acquisition of a Ukrainian business indirectly by means of purchasing shares in foreign holding companies that own the shares in the Ukrainian business. However, such approach causes foreign investors to perform due diligence of both a Ukrainian operating business and a foreign holding vehicle, which increases the acquisition costs.

The following sections discuss in greater detail the salient tax implications of purchasing shares in or assets of a Ukrainian business. The key advantages and disadvantages of asset and share deals are summarized at the end of this report.

Purchase of assets

A purchase of assets generally results in an increase to the fair market value in the cost base of the acquired business assets for both accounting and tax purposes. This tax treatment is favorable for the buyer but not the seller, which is subject to tax on income derived or capital gains (recapture of tax depreciation) realized on the disposition of assets. Most asset sales also trigger VAT at a rate of 20 percent, which is an important consideration for the buyer.

In most cases, asset deals prevent the buyer from assuming the inherent tax liabilities, tax losses and/ or tax attributes associated with the assets of the selling business.

Ukrainian business assets are typically purchased by a special-purpose Ukrainian company that is specifically set up by the buyer to accommodate the transaction. In theory, a foreign company also can purchase most assets, either directly or through a branch in Ukraine. In practice, these situations are rare, and there could be regulatory or other restrictions in terms of carrying on certain business activities or owning certain assets by foreign companies or their Ukrainian branches. Among other things, the Ukrainian tax authorities' view is that a foreign company that owns Ukrainian real estate should register a Ukrainian branch (permanent establishment) for purposes of renting this real estate.

Contributions in kind to the share capital of Ukrainian companies are possible and can bring additional fiscal benefits in terms of deferral of or exemption from customs duties on importing assets (e.g. machinery and equipment) to Ukraine.

Purchase price

The seller and buyer are free to negotiate the asset purchase price and to reasonably allocate the agreed price between the specific business assets.

Consideration should be given to signing two or more asset purchase agreements to separate supplies of business assets that are subject to VAT from supplies that are not. The same approach applies to purchases of assets that are subject to a notary deed, and, as a result, give rise to a state duty or notary fee.

After the enactment of comprehensive transfer pricing rules, the tax authorities can challenge and adjust the negotiated purchase price in the context of controlled (only cross-border) transactions.

Unlike many other jurisdictions where transfer pricing rules apply to controlled transactions between the related persons only, the Ukrainian transfer pricing rules also apply to transactions of Ukrainian resident companies with unrelated persons that are resident in the prescribed low-tax jurisdictions or are incorporated using the prescribed legal form (see also 'Transfer pricing' later in this report).

Goodwill

The Tax Code defines goodwill as an intangible asset, the value of which is equal to the difference between the fair market value and balance sheet value of assets acquired as part of the purchase of a business as a going concern (so-called 'property complex' or equity securities). Goodwill cannot be deducted or capitalized and amortized for corporate income tax purposes.

For statutory accounting purposes, negative goodwill should be allocated between the groups of assets that generate cash flows. Positive goodwill represents income.

Depreciation

With the exception of land and natural resources, the cost of other fixed assets used in business activities is capitalized and depreciated for corporate income tax purposes. In certain instances, businesses are required to capitalize interest expenses for both accounting and tax purposes.

A fixed asset with a cost exceeding UAH6,000 (about US$215) and useful economic life exceeding 1 year is allocated to one of 16 classes of fixed assets.

In many aspects, the computation of tax depreciation and amortization is aligned with the computation of accounting depreciation and amortization. Specifically, businesses can determine the period of useful economic life of fixed assets in their internal accounting policies, provided this period is not less than the minimum period prescribed in the Tax Code.

The minimum statutory periods vary from 2 years (for computers and similar electronic devices) to 20 years (for real estate).

A business can also apply an accounting method (except the production method) for tax depreciation purposes.

The cost of land and natural resources is added to classes 1 and 13, respectively, but cannot be depreciated.

The costs of repairing and enhancing of fixed assets (including leasehold) are usually capitalized and depreciated in accordance with the accounting principles.

Except for goodwill, intangible assets are allocated to one of six classes and are amortized over the period of their useful economic lifetime. The latter period cannot be less than the minimum period prescribed by the Tax Code and usually ranges from 2 years (for copyright and related rights) to 5 years (for patents, knowhow, etc.).

The minimum period of useful economic life is not prescribed for many types of intangible assets and is determined with reference to the relevant legal documents. If the legal documents are silent on the period, it is determined by the taxpayer but the period cannot be less than 2 years or more than 10 years.

Tax attributes

Tax losses, VAT receivables (credits/ refunds) and other tax attributes are not transferred to the buyer during an asset deal. Tax losses and attributes remain with the seller, which can generally use them to shelter the taxable income, gains and VAT liabilities that can arise on the disposition of assets.

Value added tax

No VAT exemption is available for a sale of a business as a going concern. As a result, a sale of business assets by a registered VAT payer is a supply of goods for VAT purposes. Supplies of goods are usually subject to VAT at a rate of 20 percent, unless the supply is VAT-exempt (e.g. supplies of securities, including shares, and equity interests).

In practice, foreign investors often set up a special-purpose Ukrainian company that purchases business assets from an operating Ukrainian business. The Tax Code provides a simplified procedure for applying for a VAT account number. Failure to obtain a VAT number before the asset transfer would prevent the newly created company from claiming a credit (refund) of VAT paid in connection with the asset purchase.

The amount of VAT that a buyer incurs on local acquisitions of assets can usually be credited against the VAT liabilities of the buyer in computing the final VAT payable to (or refundable from) the budget, provided the buyer is registered as a VAT payer before the asset purchase. The input VAT in excess of the VAT liabilities may be used to offset VAT liabilities in subsequent tax periods, be refunded to the buyer or credited against other taxes payable to the state budget.

Transfer taxes

There is no stamp duty, real estate transfer tax or similar transfer tax in Ukraine. However, the transfer of title in certain assets (i.e. land, real estate, vehicles, etc.) is usually subject to a notary deed and/ or state registration. Notary deeds give rise to a state duty administered by public notaries or a notary fee administered by private notaries.

A notary fee cannot be less than the state duty. The state duty rates depend on the type of arrangement (or deed) and are usually calculated as a percentage of the deed (transaction) value.

Specifically, the transfer of legal title in land and real estate is subject to a state duty of 1 percent of the purchase price.

In addition to the state duty, the buyer may be required to pay the 1 percent pension fund duty on purchases of real estate. A pension fund duty of 3 to 5 percent of the vehicle's value applies to the purchases of vehicles that are subject to their first registration with the State Traffic Patrol Department in Ukraine (i.e. either new or imported vehicles).

Purchase of shares

Most business acquisitions in Ukraine are structured as share deals. High-profile acquisitions of Ukrainian businesses are usually structured by means of purchasing shares in a foreign holding company that owns shares or equity interests in Ukrainian companies. Traditionally, English law has governed most share purchase agreements involving foreign investors.

In a share deal, the buyer of shares cannot pick and choose which assets of the target business to purchase, unless preliminary restructuring has been implemented to spin-off or dispose of unwanted assets before the contemplated share deal.

A share deal does not enable the buyer to increase the tax base of the assets of the purchased Ukrainian business.

The buyer can potentially benefit from available tax loss carryforwards of the acquired Ukrainian company (either directly or indirectly by merging the purchased Ukrainian company with a profitable Ukrainian group company). In Ukraine, there are no limitations that prevent the purchased company from utilizing tax loss carryforwards following a change of control. However, there are restrictions on tax losses carried forward in corporate reorganizations.

With controversial jurisprudence and no clear rules in the Tax Code on this matter, the Ukrainian tax authorities have historically challenged tax loss carry forwards arising on corporate reorganizations. However, KPMG in the Ukraine is aware of several rulings made by courts of appeal and High Administrative Court of Ukraine in 2017 claiming that successor could carry forward the accumulated tax losses of the predecessor.

By acquiring shares in the target company, the buyer effectively assumes inherent tax and other risks of the purchased company. To understand the tax position of the target business and the nature and quantum of the potential tax exposures, it has become a good business practice for buyers to initiate pre-acquisition tax due diligence of the target Ukrainian business. Among other things, the tax findings help the buyer decide whether a share deal is viable and whether the identified tax exposures are tolerable and/or manageable.

Prospective buyers often use the following approaches to mitigate or manage the pre-acquisition tax exposures of the target companies:

— negotiating adjustments to the purchase price to factor the identified tax exposures

— deferring the payment of the purchase price (either wholly or partially) or making such payment conditional on satisfaction of certain requirements

— incorporating protective provisions (so-called 'tax warranties and indemnities') in the share-purchase agreement.

The following sections discuss in more detail these and other important tax-related issues that sellers or buyers typically consider in the context of share deals.

Tax indemnities and warranties

As discussed earlier, a buyer inherits historical tax liabilities and potential tax penalties of the target business. Thus, it has become a normal business practice for buyers to require sellers to provide warranties on important tax matters and to indemnify any tax liabilities and penalties attributable to a period before closing.

Tax warranties and indemnities are usually extended to all businesses that are included in the deal perimeter. The specifics of indemnity coverage are an important aspect of negotiations between sellers and buyers of Ukrainian businesses.

Tax losses

Generally, Ukrainian companies can carry forward business losses and capital losses (i.e. losses realized on transactions with securities) indefinitely. However, from time to time, the Parliament restricts the utilization of tax losses carried forward.

Specifically, all unutilized business tax losses that arose in 2011 or prior years are divided in four equal parts, and each part could be utilized in 2012 through 2015 pursuant to a special procedure. Unutilized business tax losses can be utilized in 2016 and later years without restriction.

There are no restrictions on the carry forward and deductibility of business tax losses arising in 2012 or subsequent taxation years.

No carry back of business or capital tax losses is allowed. Neither the change of control nor the related-party nature of the share deal affects a business's ability to carry over and utilize accumulated tax losses in subsequent tax periods.

The specifics of tax loss carry forwards in the context of reorganization transactions are outlined later in this report.

Corporate income tax

Capital gains realized by Ukrainian companies on the disposition of equity interests, other than securities, are subject to corporate income tax at a rate of 18 percent as part of regular (business) income.

No participation exemption applies to capital gains. There are special tax rules for calculating and accounting for capital gains or losses on transactions with securities.

Capital gains realized by non-residents of Ukraine on the disposition of Ukrainian shares or equity interests are technically subject to withholding tax (WHT) at a rate of 15 percent. This WHT can be fully eliminated or partially mitigated under a tax treaty.

Value added tax

In Ukraine, acquisitions of shares or equity interests are not subject to VAT. Generally, share-for-share exchanges and similar transactions with shares (equity interests) are also not subject to VAT.

Transfer taxes

There is neither a stamp duty nor a similar transfer tax applicable to transfers of Ukrainian shares or equity interests. Also, there are no capital or similar taxes applicable to or computed with reference to capital in general or share capital (increase in share capital) in particular. A nominal registration charge applies for registering amendments to the corporate charter in connection with the change in ownership of equity interests. For each issuance of securities (including shares and bonds), a state duty applies of 0.1 percent of the nominal value of shares issued (but not more than 50 minimum monthly cost of living, as prescribed at 1 January of the year; about US$3,200 in 2018).

Crystallization of tax charges

The general tax statute of limitations is 3 years (1,095 days) following either the deadline for filing the relevant tax return or the return's actual date of filing, whichever date is later. For transfer pricing assessments, the statute of limitations is 7 years (2,555 days).

The tax statute of limitations does not apply where:

— a company official is found guilty of tax evasion or criminal prosecution is terminated based on 'non-rehabilitation' grounds, or

— a return for a particular period is not filed.

Generally, tax underpayments identified after the tax statute of limitations has elapsed can no longer be enforced. Similarly, tax refunds can only be claimed within 3 years following the date of tax overpayment or tax refund entitlement.

Tax returns cannot be amended beyond the tax statute of limitations. Also, amending a filed tax return re-opens the statute of limitations in respect of such tax return.

Tax clearance

No tax clearance (either advance or after-the-fact) is required from the tax authorities for a direct or indirect change in ownership of a Ukrainian business. However, the tax authorities can audit Ukrainian companies prior to a corporate reorganization.

In practice, buyers often require sellers to provide recent tax reconciliation statements or similar tax documents on the tax position of the target business. Such documents are issued by the tax authorities to notify businesses of the status of tax payments, refunds and indebtedness as per the records of the tax authorities. Some sellers manage to obtain such tax documents on or immediately before closing the share deal. Recently, the procedure for obtaining such tax reconciliation statements was simplified, and, through a new electronic service, Ukrainian taxpayers can request and receive such

tax reconciliation statements automatically via their personal 'electronic cabinets'.

Note that these tax documents may not represent the actual status of tax payments, refunds and indebtedness. Thus, buyers cannot rely on them as evidence that the target business does not have any outstanding tax liabilities. Also, such tax documents cannot substitute tax due diligence of the target business. Subsequent tax audits can reveal additional tax liabilities and trigger additional tax arrears interest and penalties that are not reflected in the tax reconciliation statements.

Choice of acquisition vehicle

Foreign investors can acquire Ukrainian businesses either directly or indirectly using one of the acquisition vehicles discussed below. Tax, legal and regulatory considerations typically affect the choice of acquisition vehicle.

Local holding company

Foreign investors often set up a Ukrainian acquisition company for the purposes of acquiring Ukrainian business assets.

For share deals, the use of a local holding company could be beneficial for purposes of implementing the debt pushdown structure, unless certain fiscal and corporate considerations make a debt pushdown structure unviable. A local acquisition company (LLC) is usually chosen for share deals where a two-tier Ukrainian structure is required due to regulatory or other legal restrictions on direct ownership of Ukrainian assets or businesses by foreign investors.

Foreign parent company

Strategic investors often opt to invest in or acquire the Ukrainian shares, either directly or through regional acquisition vehicles. This can also be the case where a tax-efficient structure is already in place (i.e. where a Ukrainian business is acquired by the foreign parent company indirectly by means of purchasing the foreign holding company that owns the Ukrainian business).

Also, the Ukrainian privatization requirements can leave strategic foreign investors no option but to acquire the Ukrainian business directly rather than through a special-purpose vehicle set up, say, in a tax haven jurisdiction.

Non-resident intermediate holding company

Foreign intermediate holding companies are common acquisition vehicles for share deals, especially where the Ukrainian shares are purchased directly. The choice of an intermediate holding company is primarily driven by the tax considerations to locate an acquisition vehicle in a jurisdiction that has a favorable tax treaty with Ukraine.

Ukraine has a broad network of tax treaties. Many of them exempt capital gains realized by foreign companies on dispositions of shares from taxation in Ukraine, provided the shares' value is not primarily derived from real property located in Ukraine. Tax treaties often exempt dividends, interest and royalties from Ukrainian income taxation or provide for beneficial WHT rates.

Although the use of an intermediate company in a treaty country can be fiscally beneficial, consideration should be given to treaty shopping and limitation of benefits provisions in tax treaties, and to the beneficial ownership requirement of the domestic taxation system.

Local branch

A local representative office (or branch) of a foreign company is subject to state and tax registration in Ukraine and is not commonly used for acquiring Ukrainian business assets or shares. The tax status of a local representative office depends on whether or not its activities give rise to a permanent establishment of the foreign company in Ukraine. Generally, taxation of a permanent establishment is similar to taxation of a regular Ukrainian company.

The key tax benefits of using a local branch are the absence of a branch tax and, in certain instances, advance corporate income tax on distribution of Ukrainian after-tax earnings. Ukrainian WHT may not apply to distributions of after-tax earnings based on a non-discrimination clause of the relevant tax treaty. But most of these tax benefits are of limited use as it is also possible to achieve nil WHT on distribution of Ukrainian dividends under certain tax treaties. Certain tax and regulatory considerations can make a local branch less attractive than a regular Ukrainian company.

A local branch can be a feasible solution where a foreign investor decides to purchase Ukrainian real estate directly and then rent it to Ukrainian and foreign lessees.

Joint venture

Where a foreign investor decides to invest in Ukraine together with Ukrainian and/or foreign business partners, such investments can be structured through a Ukrainian-incorporated vehicle or a contractual joint venture arrangement.

A Ukrainian LLC or, to a lesser extent, a joint stock company (JSC) is often chosen by foreign investors to incorporate a joint venture in Ukraine. The tax treatment and status of an incorporated joint venture is not different than that of a regular Ukrainian company.

A foreign investor can set up a contractual joint venture with a local partner by executing a joint venture agreement (formally referred to as 'a joint activity agreement', which can usually take the form of a classic joint venture agreement or a production sharing agreement).

A classic joint activity agreement should designate a partner (member) that is responsible for maintaining accounting

records, preparing financial statements (which are not filed with the tax or statistical authorities), filing tax returns (e.g. VAT returns) (where required) and paying any taxes for and on behalf of the joint venture. Generally, except for certain limited instances, joint activity agreements should be registered with the tax authorities.

The designated partner (member) is responsible for maintaining financial and, where applicable, tax records of the joint venture. Even though joint venture arrangements are registered for tax purposes, such arrangements are not payers of corporate income tax. Therefore, the members of the joint venture arrangement include in their corporate income tax returns the relevant share of the joint venture's profit or loss that is computed by the designated partner (member).

The joint venture could also be registered as a separate VAT payer in Ukraine (where the joint venture meets the general VAT registration requirements). Transactions of a member in the joint venture relating to transfer of any assets to and from the joint venture are generally subject to VAT.

Taxation of joint venture activities is not adequately addressed in the Tax Code of Ukraine, and the relevant tax rules lack detail and clarity. In practice, foreign investors rarely use joint venture agreements to invest or do business in Ukraine. The use of a contractual joint venture is predominately limited to energy (oil and gas) and infrastructure projects (including private-public partnership projects).

Choice of acquisition funding

A Ukrainian acquisition vehicle usually can be financed by means of debt, equity or, in theory, a hybrid instrument that has attributes of both. Non-monetary acquisitions (including share-for-share exchanges) are rare in Ukraine.

Debt

Debt financing is more tax-efficient than equity financing as debt financing enables the borrower to deduct interest expense against taxable earnings and thus reduce corporate income tax payable.

In practice, Ukrainian acquisition vehicles often do not have sufficient earnings against which the interest on loans can be deducted. In many jurisdictions, various debt pushdown strategies are used to match business earnings of the purchased operating business with interest expense of the local acquisition vehicle. As of 2018, debt pushdown strategies are also viable in Ukraine.

Debt financing of Ukrainian businesses is usually structured through interest-bearing or interest-free loans. Foreign exchange gains or losses that arise on such loans and accrued interest are usually taxable or tax-deductible, as the case may be, for corporate income tax purposes.

Subject to the thin capitalization requirements discussed later in this report, accrued interest expense is usually deductible for corporate income tax purposes.

Interest-free loans do not give rise to imputed interest for Ukrainian borrowers. However, imputed interest, transfer pricing adjustments and/ or other negative tax implications could arise in a jurisdiction of a foreign lender of an interest-free loan.

Deductibility of interest

Generally, accrued interest expense is tax-deductible where interest is deductible for accounting purposes and Ukraine's thin capitalization requirements are met.

If loans from related non-resident lenders exceed the net equity of the Ukrainian borrower by 3.5 times, the Ukrainian borrower could claim a tax deduction in respect of the accrued interest only to the extent this interest does not exceed 50 percent of the Ukrainian borrower's earnings before interest, taxes, depreciation and amortization (EBITDA). For financial institutions and leasing companies, the debt-to-net equity ratio is 10:1.

If the thin capitalization rule applies, then all interest payable to both the related foreign lenders would be subject to the tax limitation referred to above.

Interest expenses that are not tax-deductible in a taxation year due to the thin capitalization rule are carried forward indefinitely and could be deductible in a future taxation year in which the thin capitalization requirements are met. The interest carry forward amount is depreciated by 5 percent on an annual basis so that only 95 percent of the carried forward amount would be tax-deductible in the next taxation year.

Withholding tax on debt and methods to reduce or eliminate it

Interest payments to non-resident lenders are subject to WHT at a general rate of 15 percent. However, such WHT can be mitigated or eliminated where the foreign lender is a tax resident in a jurisdiction with which Ukraine has an effective tax treaty and the foreign entity is the beneficial owner of the Ukrainian-sourced interest. A valid tax residency certificate of the foreign lender is usually required to enable the Ukrainian borrower to access preferential treaty WHT rates.

Where an intermediary financing vehicle is used, consideration should be given to the beneficial ownership requirements.

Checklist for debt funding

Loans from non-residents of Ukraine must be formally registered with the National Bank of Ukraine before Ukrainian corporate borrowers can actually receive the borrowed funds.

The currency control regulations establish certain limits (thresholds) on such borrowings. These limits depend on the

type of currency and loan maturity. Currently, the maximum allowed interest rates for borrowings in first-class hard currencies (including commission fees and financial penalties) are as follows:

— short-term foreign loans (with maturity of less than 1 year) — maximum 9.8 percent

— mid-term foreign loans (with maturity from 1 to 3 years) — maximum 10 percent

— long-term foreign loans (with maturity exceeding 3 years) — maximum 11 percent.

Consideration should be given to the reduction of the 15 percent WHT rate under a relevant double tax treaty.

Significant devaluation of the Ukrainian currency (UAH) relative to major foreign currencies prompted the National Bank of Ukraine to introduce a number of painful currency control restrictions and limitations. In particular, Ukrainian companies can repay cross-border loans before their maturity dates only within a limit of US$2 million in a calendar month.

Equity

An acquisition of a Ukrainian business can also be financed by means of equity. Equity financing usually takes the form of cash or in-kind contributions. Where a local company has retained earnings, the share capital can be increased by means of a stock dividend. Foreign shareholders can register their capital contributions to share capital of Ukrainian subsidiaries as foreign investments to enhance state protection of investments, the ability to return investments and earned income. The state registration of foreign investments is also required to claim customs incentives in connection with in-kind contributions.

All capital contributions to the registered share capital are exempt from corporate income tax. A share premium (i.e. capital contribution exceeding nominal registered share capital) should also be exempt from corporate income tax. Dividend payments are not tax-deductible. A return of equity is exempt from corporate income tax and is not tax-deductible. Foreign exchange gains or losses that can arise in connection with equity financing are neither taxable nor tax-deductible for corporate income tax purposes.

Capital contributions in cash can be transferred either directly from a foreign bank account of the foreign shareholder or through a local currency investment account that a foreign shareholder can open in a Ukrainian bank.

Contributions in kind are usually subject to VAT at a rate of 20 percent, unless the supplies of contributed assets are specifically exempt from VAT. The import VAT is usually paid by the Ukrainian company on the customs clearance of contributed assets and can be claimed by the Ukrainian company as a VAT credit in the same taxation period (month).

The tax cost of contributed assets can be depreciated (amortized) or deducted, as the case may be, for corporate income tax purposes.

Foreign investors can also benefit from a customs incentive available for contributions in kind of assets (typically, machinery and equipment). Specifically, no customs duties apply to the importation of assets that are contributed to the share capital of a Ukrainian business. The business must own the contributed assets for the following 3 consecutive years; otherwise, the unpaid customs duties become due.

Dividends paid to foreign shareholders that represent capital gains derived by foreign shareholders from the return of capital (as a positive difference between capital contribution and return of equity) are subject to the 15 percent WHT unless the tax is reduced or eliminated under a tax treaty. Consideration should be given to the beneficial ownership requirement that is now part of the Tax Code, which can prevent a foreign shareholder from enjoying preferential WHT rates for dividends.

As noted, in late 2014, due to the significant devaluation of the Ukrainian currency (UAH) relative to major foreign currencies, the National Bank of Ukraine introduced a set of harsh currency control restrictions. Starting early 2017, the National Bank of Ukraine lifted most of these restrictions and starting from 3 March 2018 the National Bank of Ukraine softened the remaining currency control restrictions to make Ukraine more attractive for foreign investors. Currently, the main currency control restrictions in place relate to:

— mandatory sale of 50 percent of foreign currency proceeds received by Ukrainian businesses (except for cross-border loans obtained by the Ukrainian businesses to refinance their existing loans)

— a ban on early repayments of loans and loan interest exceeding US$2 million in a calendar month (except for certain cases)

— a ban on payments of dividends to foreign investors exceeding US$7 million in a calendar month

— a ban on payment of the result of share capital decrease or withdrawal of a non-resident of Ukraine from the Ukrainian business (unless the payment does not exceed US$5 million per calendar month).

When these temporary currency control restrictions will be lifted or softened is not known.

In certain instances, Ukrainian companies are required to accrue and remit to the budget an advance corporate income tax at a rate of 18 percent before distributing dividends. In particular, this advance income tax could be paid in situations when the accounting profit distributable as dividends for a particular year exceeds the taxable income (profit) declared by the dividend payer for the same year. The paid tax can be

credited against the corporate income tax liabilities of the Ukrainian dividend distributor.

Tax–free reorganizations

Corporate reorganizations can take various legal forms, namely, a merger, acquisition (takeover), split-up, spin-off or transformation of a corporate body. Reorganization is usually initiated by a resolution of the general shareholders' meeting. However, in certain instances (e.g. where a company is abusing its dominating position on the market), the Antimonopoly Committee of Ukraine may force the company to split up.

In practice, corporate reorganizations are performed on a tax-deferred basis, even though the Tax Code of Ukraine is mute on the corporate income tax implications for the companies involved and their shareholders. To be on a safe side, the companies usually apply for and obtain private tax rulings to confirm the tax-neutral treatment of corporate reorganizations from a corporate income tax perspective.

Corporate reorganizations are specifically exempt from VAT. As a result, a transfer of assets from a reorganized business to a successor company as part of a corporate reorganization should be exempt from VAT.

Tangible and intangible assets are usually recorded in the balance sheet of the successor company using the book values of the predecessor company.

Special rules apply on allocating and/ or settling tax liabilities and/or overpayments (refunds) of reorganized companies. Consideration should be given to the VAT position of reorganized businesses. As of 1 January 2017, a special clause was added to the Tax Code covering carry forwards of accumulated VAT credits as part of corporate reorganizations. In particular, the Tax Code currently allows Ukrainian taxpayers to transfer the accumulated VAT credits of a predecessor to a legal successor on signing a transfer act and distribution balance (in this case, proportionally to the part of business distributed).

Given that the Tax Code is mute on the corporate income tax implications of corporate reorganizations, the Ukrainian tax authorities are of the view that a surviving company cannot report and utilize business and capital losses of a predecessor company that is terminated in the course of a corporate reorganization (see 'Purchase of shares' on recent developments in tax jurisprudence).

Hybrids

The recent tax changes have effectively aligned the accounting and tax treatment of a transaction or instrument. Also, the tax definition of 'interest' and registration requirements for foreign loans make it difficult to successfully implement tax planning strategies that involve profit-sharing loans. A distribution of retained earnings is treated as a dividend payment, and the nature of such payment usually remains the same regardless of the type of the share (common or preferred) on which it is paid.

Even though preferred stock dividends paid to individuals are deemed to be salaries for tax purposes, it is doubtful that the tax authorities would allow a tax deduction in respect of such dividend payments as there is no clear rule in the Tax Code of Ukraine that would allow such tax deduction.

In general terms, an interest payment on a loan or other debt obligation is treated as interest for tax purposes as long as it is treated as such for accounting purposes.

Discounted securities

A discount on any kind of debenture or other security is effectively treated and taxed as interest. Thus, income derived by a non-resident of Ukraine in the form of a discount on transactions with securities should be subject to the 15 percent WHT unless this tax is eliminated or mitigated under a tax treaty.

Deferred settlement

An acquisition of a business often involves an earn-out mechanism or other form of deferred settlements where a portion of consideration can be determined and/ or paid only at some point in the future. No specific tax rules address the tax treatment of deferred consideration in the context of acquisition transactions. The actual tax consequences usually depend on the specifics of the agreed price determination and the timing and payment mechanisms outlined in the share-purchase agreement, and they would usually be aligned with the accounting treatment.

Other considerations

Concerns of the seller

The tax consequences for the seller largely depend on the seller's residency status, form of the transaction (i.e. asset or share deal), specifics of the price arrangement and certain other important factors.

Sale of assets

The seller would be primarily concerned with the possible income tax implications of the sale of assets, namely, recapture of tax depreciation where depreciable assets are sold and taxation of realized gains (income) on the disposition of other assets. Available business and/ or capital losses can help to decrease the income tax liabilities.

The buyer usually pays the VAT, pension tax and various state duties that can potentially apply to sales of assets. As a result, these taxes should not pose a concern for the seller.

The seller should also plan what to do and/or how to extract proceeds of disposition tax-efficiently. This is very important for Ukrainian sellers, especially in the context of the legislative currency control restrictions on dividend payments, returns of capital and premature repayments of loans and interest.

Sale of shares

The seller should primarily be concerned with the Ukrainian income tax and WHT implications of selling the shares or equity interests in Ukrainian companies, as discussed earlier. Because sales of shares and equity interests are not subject to VAT, this tax should not be a concern for the seller.

The seller can consider whether it would be tax-efficient to sell a Ukrainian business directly or indirectly (i.e. at the level of the foreign holding company). An indirect sale often helps defer taxation of the realized capital gain unless and until the relevant proceeds are distributed to the ultimate beneficiary by the foreign holding company.

The seller should also pay attention to available tax shields (i.e. tax losses or attributes) that can be used to decrease the tax liabilities. A possibility to structure a disposition of the shares on a tax-deferred rollover basis can also be explored.

Company law and accounting

In Ukraine, common corporate forms are LLCs and JSCs. Unlike LLC, a JSC is entitled to issue shares, which are subject to registration with the State Securities and Exchange Commission.

Similar to a JSC, the liability of LLC's shareholders (participants) is limited to their investment in the share capital. Requirements for the incorporation and operation of LLC are simpler and more straightforward than those prescribed for a JSC.

A Ukrainian company (LLC or JSC) should be registered with the state registrar, tax, pension (social security) and statistical authorities.

Currently, there is no minimum share capital requirement for LLC. But if founders decide to make capital contributions and register share capital of an LLC, they should contribute 100 percent of the declared share capital in cash or in-kind within 1 year from the date of LLC's incorporation.

The minimum share capital of a JSC is set at 1,250 minimum monthly salaries as set by the state as of 1 January of each year (for 2018, this amount approximates US$175,400). Shareholders of a JSC shall pay their shares in full before the company's state registration.

LLC's shareholder (participant) may alienate its equity interest in the LLC's capital to a third party, unless otherwise provided in the LLC's charter. In this case, other LLC participants are entitled to receive the first offer to purchase its share (equity interest).

Shareholders of a public JSC may sell their shares without any restrictions or commitments to other shareholders. Shareholders of a private JSC, however, may sell their shares subject to the right of first refusal granted to other shareholders.

Ukrainian law provides for other legal forms of doing business in Ukraine, including representative offices (branches) and joint activity agreements. However, these structures are rarely used to acquire a Ukrainian business.

Under Ukrainian law, International Financial Reporting Standards (IFRS) is compulsory for public interest entities, mining enterprises extracting minerals of national importance, banks, insurance companies, other financial institutions and public JSCs. Other companies can choose to apply IFRS reporting.

Group relief/consolidation

There is no tax consolidation in Ukraine, and each legal entity is taxed on a standalone basis.

Transfer pricing

In 2017, the transfer pricing rules were revised and amended.

Pursuant to the new rules, transactions are deemed to be controlled where the annual transaction volume (excluding VAT) between the two parties exceeds UAH10 million (approximately US$376,800) and the annual revenues of the taxpayer exceed UAH150 million (approximately US$5.7 million).

Transactions between the related resident companies do not fall within the ambit of controlled transactions.

The controlled transactions of a Ukrainian company encompass its transactions with the following persons, where the annual transaction volume (excluding VAT) of such transactions exceeds UAH10 million (about US$376,800):

— a related non-resident person

— an unrelated person which resides in a prescribed low-tax jurisdictions

— an unrelated person that is incorporated in the specific legal form and either does not pay corporate income tax on income received outside the country of its registration or is not a tax resident in the country of its registration

— a non-resident commissioner.

Also, as of 1 January 2018, transactions between non-resident of Ukraine and its branch (permanent establishment) in Ukraine could also be viewed as 'controlled' provided that the volume of such transactions exceed UAH10 million (about US$376,800).

For purposes of determining whether or not two persons are related, a person is deemed to exercise control over the taxpayer if they hold, directly or indirectly, at least 20 percent of the corporate rights of the taxpayer or 20 percent of the voting rights. For an individual, the total holding is determined as the total sum of the corporate rights that belong to the individual or their family members and the legal entities controlled by the individual or family members.

Controlled transactions should be reported by 1 October of the year following the reporting year.

There are significant penalties for failure to report or incomplete reporting of controlled transactions before the reporting deadline.

Dual residency

Ukrainian companies do not use intentional dual residency. Under Ukrainian tax laws, the place of incorporation (state registration) determines a company's tax residency. However, where management of a foreign company is located in Ukraine, this could give rise to a permanent establishment of the foreign company in Ukraine.

Foreign investments of a local target company

In Ukraine, there is no anti-avoidance legislation (controlled foreign company rules) with respect to controlled foreign affiliates of Ukrainian companies. As a result, income earned by foreign affiliates of Ukrainian companies is not subject to income taxation in Ukraine unless and until this income is actually distributed as dividends to the Ukrainian parent company. However, informational tax returns (forms) are still filed by parent Ukrainian companies in respect of their foreign affiliates.

Special tax rules and restrictions can apply to transactions of Ukrainian resident companies with foreign businesses that are located or have bank accounts in tax haven jurisdictions. The Ukrainian government periodically updates the official list of tax haven jurisdictions.

Comparison of asset and share purchases

Advantages of asset purchases

— Possible to choose the required assets or acquire only part of the business.

— Buyer does not usually assume tax liabilities and tax exposures of the target business.

— A loss-generating entity can acquire profit-generating assets to utilize tax losses.

— Possible to achieve a step-up in assets' cost bases for accounting and tax purposes.

— A portion of the purchase price can be depreciated or amortized for tax purposes.

Disadvantages of asset purchases

— Asset deals are usually more time-consuming and expensive to implement.

— Asset sales may be taxable and less attractive to the seller, increasing the purchase price.

— VAT, state duty and pension charges may be payable, increasing the buyer's costs.

— Tax losses remain with the seller, so the buyer does not benefit from them.

— Acquisition of collateral assets can pose a problem.

— Transfer of licenses and permits to the buyer is usually not possible.

— Deferred customs duties can be due on the sale of certain imported assets.

Advantages of share purchases

— Capital gains realized by foreign shareholders can be exempt from taxation or taxed at preferential tax rates.

— Share deals can be exempt from income taxation in Ukraine (e.g. where the Ukrainian shares are owned by non-residents of Ukraine).

— Share deals are exempt from VAT and not subject to other material taxes in Ukraine.

— Transfer of licenses and permits to the buyer is usually possible.

— Often more attractive to sellers, so the purchase price may be lower.

— Buyer can benefit from available tax loss carry forwards of the acquired business.

— Less disruptive for the acquired business.

Disadvantages of share purchases

— Buyer is liable for any claims and liabilities of the acquired company.

— Difficult to implement where there are numerous minority shareholders.

— Buyer is often not able to deduct the purchase price until the acquired shares are subsequently disposed of.

— Capital gains realized by Ukrainian companies are subject to income taxation.

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United Kingdom

Introduction

The United Kingdom (UK) tax environment for mergers and acquisitions (M&A) continues to change in response to the fiscal climate, perceived competitiveness pressures from other countries and challenges to existing UK legislation under European Union (EU) non-discrimination principles.

This report begins by reviewing recent changes that are likely to affect the approach to transactions. This report proceeds by addressing three fundamental decisions that face a prospective buyer:

— What should be acquired: the target's shares or its assets?

— What will be the acquisition vehicle?

— How should the acquisition vehicle be financed?

Of course, tax is only one piece of transaction structuring. Company law governs the legal form of a transaction, and accounting issues are highly relevant when selecting the optimal structure. These areas are outside the scope of this report, but some of the key points that arise when planning a transaction are summarized within this report.

Recent developments

The following summary of UK tax considerations is based on current tax legislation up to and including the Finance (No.2) Act 2017, along with future developments expected as of 1 February 2018.

Deductibility of interest

In response to recommendations of the Organisation for Economic Co-operation and Development (OECD) under Action 4 of its Action Plan on Base Erosion and Profit Shifting (BEPS), the UK has enacted a corporate interest restriction, discussed in more detail below.

Loss reform

Income type losses (e.g. trading losses) arising after 1 April 2017 can be carried forward and offset against total profits and, subject to certain conditions, surrendered as group relief. In either case, offset is limited to 50 percent of taxable profits.

Asset purchase or share purchase

An acquisition in the United Kingdom usually takes the form of a purchase of the shares of a company, rather than its business and assets, because capital gains on the sale of shares may be exempt. From a tax perspective, the capital gains consequences, the likely recapture of capital allowances (tax depreciation), and possible double taxation on extracting the sales proceeds are all likely to make asset acquisitions less attractive for the seller. The benefits of asset acquisitions for the buyer have been reduced as purchased goodwill no longer attracts a tax deduction. Some of the tax considerations relevant to each method are discussed later in this report. The relative advantages are summarized at the end of this report.

Purchase of assets

A purchase of assets usually results in an increase in the base cost of those assets for both capital gains tax and capital allowances purposes, although this increase is likely to be taxable to the seller. In addition, historical tax liabilities generally remain with the company and are not transferred with the assets. Of course, the buyer may still inherit defective practices or compliance procedures, so the buyer may wish to carry out some tax due diligence to identify and address such weaknesses.

Purchase price

For tax purposes, it is necessary to apportion the total consideration among the assets acquired. It is generally advisable for the purchase agreement to specify the allocation, which is normally acceptable for tax purposes, provided it is commercially justifiable. However, two statutory rules affect the allocation of the purchase price:

— The first rule stipulates that the open-market value of trading stock must be substituted in calculating the profits of the seller.

— The second rule requires that the buyer's cost of acquisition and the seller's disposal proceeds for capital allowance purposes be calculated through a just apportionment of total consideration.

Goodwill and intangibles

Goodwill purchased from a third party on or after 8 July 2015 is not deductible.

With the exception of customer-related information, customer relationships and unregistered trademarks, other separately identifiable intangible assets are written off for accounting purposes over their expected useful economic lives. Such amortization is deductible for tax purposes in line with the accounts.

Depreciation

Depreciation of other assets charged in the accounts is ignored for tax purposes. UK tax legislation enables the cost of certain assets to be written off against taxable profits at a specified rate by means of capital allowances. Allowances are available for certain tangible assets (e.g. plant and machinery) and certain intangible assets (e.g. patents and knowhow), except that intangible assets created or purchased on or after 1 April 2002 usually fall within the separate regime mentioned above.

The UK capital allowances regime has been significantly amended in recent years. Allowances for industrial and agricultural buildings are no longer available, having been phased out over the period from 2008–11.

No tax write-off is normally available for office buildings or shops, although some fixtures in such buildings may themselves qualify for capital allowances. The annual rate of tax write-off for plant and machinery is 18 percent (on a reducing-balance basis) and 8 percent (reducing-balance) for certain other assets (e.g. integral features of a building).

There are special rules for cars, certain other assets, and small and medium-sized companies. Accelerated allowances and tax credits are also available for research and development expenditure. Allowances may be recaptured where the disposal of an asset yields proceeds in excess of its tax written-down value.

Tax attributes

Tax losses and capital allowances pools are not transferred on an asset acquisition. They remain with the company or are extinguished.

Where the buyer wishes to acquire a company's trade together with its tax trading losses (or capital allowances pools), the trade can be transferred to a new company (Newco), which is then sold to the buyer.

Generally, provided any liabilities not transferred to Newco are balanced by assets not transferred together with the purchase consideration for the assets transferred, the losses can be transferred with the trade and used in Newco (subject to potential restrictions where there is a major change in the nature or conduct of that trade — see 'Purchase of shares'). This route would crystallize any chargeable gains inherent in the underlying assets transferred. Such gains are treated as additional consideration for the shares and so may be exempt.

This treatment is not applicable to gains arising on intangible assets created or purchased after 1 April 2002, which continue to crystallize in the Newco.

Value added tax

Value added tax (VAT) is levied at the rate of 20 percent on many goods and services, although goods exported from the UK are not charged with VAT. The transfer of a business as a going concern is outside the scope of VAT, provided certain conditions are met. The effect of the transfer must be to put the new owner in possession of a business that can be operated as such. Therefore, a sale of assets is not in itself the transfer of a business as a going concern.

Professional advice should be sought where land or buildings are being sold. Complications arise where the transferor previously elected to bring such assets within the scope of VAT.

Transfer taxes

Stamp duty (or stamp duty reserve tax — SDRT) is levied on instruments transferring ownership of shares and applies at the rate of 0.5 percent.

Transfers of land and buildings in England, Wales and Northern Ireland are subject to stamp duty land tax (SDLT). From 1 April 2015, SDLT was replaced in Scotland with the land and buildings transaction tax (LBTT). SDLT will also be replaced in Wales from 1 April 2018. The rates of SDLT on commercial purchases, lease premiums and other non-rent payments are applied progressively and range from 2 percent, where the value transferred exceeds 150,000 British pounds (GBP), to 5 percent, where the value exceeds GBP250,000. For LBTT the commercial rates are applied progressively; the lowest rate is 3 percent, which applies to consideration above GBP150,000, and the top rate is 4.5 percent, which applies to consideration above GBP350,000.

Lease rents are taxable at 1 percent of the net present value of the rent payments where the GBP150,000 threshold is exceeded (2 percent if the net present value of the rent exceeds GBP5,000,000). There is a relief for leases where property has been sold and leased back to the seller.

Certain transfers within groups or on company reorganizations are exempt from stamp duty, SDRT, LBTT and SDLT, or attract duty at a reduced rate.

Purchase of shares

The purchase of a target company's shares does not result in an increase in the base cost of that company's underlying assets (although assets that were transferred to that target company from a retained group company within 6 years of the purchase may be re-based to their market value at the time of the transfer). There is no deduction for the difference between underlying net asset values and consideration.

Tax indemnities and warranties

In a share acquisition, the buyer is taking over the target company together with all related liabilities, including contingent liabilities. Therefore, the buyer normally requires more extensive indemnities and warranties than in the case of an asset acquisition. An alternative approach is for the seller's

business to be transferred into a newly formed subsidiary with a view to the buyer taking a clean company.

Where significant sums are at issue, it is customary for the buyer to initiate a due diligence exercise, which would normally incorporate a review of the target's tax affairs. However, there are a number of transactions where the principle of caveat emptor (let the buyer beware) applies and warranties and indemnities are not given. These situations typically include the acquisition of a UK-quoted (listed) company, a purchase from a receiver, liquidator or private equity house, and, in some cases, an acquisition of shares owned by individuals not involved in the management of the target.

Tax losses

In principle, carried forward UK tax losses generated by the target company transfer along with the company. A company's carried forward income-type losses (e.g. trading losses) arising after 1 April 2017 can be offset against the profits of other companies through group relief. Such losses cannot be surrendered as group relief to members of the acquirer group until 5 years have elapsed since the acquisition. Surrender is limited to 50 percent of the claimant's taxable profits.

Carried forward income-type losses arising after 1 April 2017 may be offset against the company's own future total profits, but offset is limited to 50 percent of those profits. The 50 percent limit also applies to carried forward income-type losses arising before 1 April 2017, and these can only be offset against future profits of the same type. The use of carried forward capital losses can be subject to severe restrictions; broadly, such capital losses may only be set off against future chargeable gains on assets held before the change in ownership or acquired for use in the trade or business from third parties after the transaction.

Where a UK target company with trading losses is acquired (whether directly or by the acquisition of its immediate or ultimate parent company), it may use those losses against its own future trading profits, provided there has been no major change in the nature or conduct of its trade 3 years before and 5 years after the date of acquisition. If the buyer intends to undertake a major rationalization of the trade or wishes to inject elements of its own trade into the target, it may be advisable to wait until at least 5 years have passed from the date of acquisition.

Where the target has investment business, there is an additional condition to satisfy on a change of ownership in order to preserve certain non-trading losses. The use of carried forward losses (e.g. financial losses, management expenses) for such companies is also restricted where there is a significant increase in the company's capital within 5 years after the acquisition. For this purpose, capital includes both debt (including accrued interest) and equity. A significant increase is an increase of GBP1 million or more that represents an increase of at least 25 percent.

Other restrictions apply where the tax written-down value of assets qualifying for capital allowances exceeds their book value by:

— GBP50 million or more, or

— GBP2 million or more and the benefit conferred by the allowances is not insignificant compared to the total benefits derived from the transaction

In these cases, losses created by claiming capital allowances can no longer be surrendered as group relief and must be carried forward in the company purchased.

The surrender as group relief of losses arising from deductions that are highly likely to arise after a change in ownership is precluded where obtaining relief for such deductions was a main purpose of the change in ownership. A complementary measure prevents relief from being obtained via the transfer of profits to the purchased company.

The purchase agreement should indicate whether the buyer or seller has the right to use the target company's pre-acquisition tax losses. In particular, the extent to which the seller has the right to use losses by way of group relief needs to be clarified. For group relief purposes, a loss arising in the accounting period in which the acquisition takes place is often apportioned on a time basis between the pre-acquisition element (available to the seller, subject to possible restrictions) and the post-acquisition element (available to the buyer). Where the seller does not or cannot claim group relief for pre-acquisition losses, they are carried forward in the target company. The indemnities and warranties in the sale and purchase agreement normally refer to the arrangements agreed between the parties.

Crystallization of tax charges

The buyer should satisfy itself that it is aware of all assets transferred to the target during the preceding 6 years by other UK companies within the seller's group. The sale of the target company causes gains inherent in those assets at the time of transfer to crystallize. Such gains are treated as additional consideration for the shares, so they may be exempt.

This treatment is not available in certain circumstances where the seller of the transfer shares is a non-UK parent company or to gains arising on intangible assets created or purchased after 1 April 2002. Such gains continue to crystallize in the subsidiary, so the buyer may wish to obtain an appropriate indemnity from the seller.

Pre-sale dividend

In certain circumstances, the seller may prefer to realize part of the value of their investment as income by means of a pre-sale dividend. The rationale is that the dividend may be subject to no or only a low effective rate of UK tax but reduces the proceeds of sale and thus the gain on sale, which may be subject to a higher rate of tax. The position is not straightforward, however, and each case must be examined on its facts.

Transfer taxes

Stamp duty is payable at the rate of 0.5 percent on the value of the consideration given for shares in a UK company. It may be possible to eliminate this liability by replacing a share purchase with a transaction in which the target's share capital is cancelled and new shares are issued to the buyer. This process can be complex and time-consuming, however, so it tends to be used only in larger transactions. Alternatively, it may be possible to reduce the liability where the target has issued debt that will be repaid on the transaction.

Choice of acquisition vehicle

Several potential acquisition vehicles are available to a foreign buyer, and tax factors often influence the choice. There is no capital duty on the introduction of new capital to a UK company or branch (or to a UK-registered societas Europaea).

Local holding company

A UK holding company is typically used where the buyer wishes to ensure that tax relief for interest is available to offset the target's taxable profits (see this chapter's information on funding) or taxable profits of other UK companies (or UK permanent establishments of non-UK companies) already owned by the buyer.

The ability to group-relieve losses (and, in a share acquisition, offset tax-deductible interest in the acquisition vehicle against UK taxable profits of other companies in the combined post-acquisition group) depends, broadly, on the relevant companies being in a 75 percent group relationship. This requirement may be satisfied where the companies have a common corporate parent, whether a UK-resident or non-resident company.

Foreign parent company

The foreign buyer may choose to make the acquisition itself, perhaps to shelter its own taxable profits with the financing costs. This does not necessarily cause any tax problems because the UK does not tax the gains of non-residents disposing of UK shares (unless held for the purpose of a trade carried on through a UK branch) and does not levy withholding tax (WHT) on dividends. However, the UK does charge WHT on interest (certain exceptions apply, notably where the debt is structured as a quoted Eurobond or deep discount security). So, where relevant, an intermediate company resident in a more favorable treaty territory may be preferred, or other structures or loan instruments that do not attract a WHT liability may be considered.

Non-resident intermediate holding company

Where the foreign country taxes capital gains and dividends received from overseas, an intermediate holding company resident in another territory could be used to defer this tax and perhaps take advantage of a more favorable tax treaty with the UK. The buyer should be aware that certain UK treaties contain anti-treaty shopping provisions that may restrict the ability to structure a deal in a way designed solely to obtain tax benefits.

Local branch

As an alternative to the direct acquisition of the target's trade and assets, a foreign buyer may structure the acquisition through a UK branch. The UK does not impose additional taxes on branch profits remitted to an overseas head office. The branch is subject to UK tax at the normal corporate rate, currently 19 percent and falling to 17 percent as of 1 April 2020. Where the UK operation is expected to make losses initially, a branch may be advantageous since, subject to the tax treatment in the head office's country, a timing benefit could arise from the ability to consolidate losses with the profits of the head office.

Unlike the disposal of a UK subsidiary by a non-resident, a disposal of a UK branch to a third party triggers a tax liability on any capital gains. However, there are provisions that should enable a transfer of the branch's trade and assets to a UK group subsidiary without any immediate UK tax cost, subject to certain conditions.

Joint venture

Joint ventures can be either corporate (with the joint venture partners holding shares in a UK company) or unincorporated (usually a UK partnership). Partnerships generally are considered to provide greater flexibility from a tax viewpoint. For example, where the joint venture is expected to make losses initially, the partners should be able to offset their shares of those losses against the profits of their existing UK trades.

By contrast, unless one of the joint venture partners has a 75 percent interest, the losses of a joint venture company are available to its owners only where the conditions for UK consortium relief are met. Broadly, this relief enables a corporate shareholder holding 5 percent or more of a loss-making UK company to use its share of the losses against the profits of any UK companies within its 75 percent group, provided 75 percent or more of the shares in the joint venture company are owned by companies of which none owns less than 5 percent. For this purpose, the 75 percent group cannot be traced through non-European Economic Area (EEA) subsidiaries.

In practice, there may be non-tax reasons that lead a buyer to prefer a corporate joint venture. In particular, a corporate body may enable the joint venture partners to limit their liability to the venture (assuming that lenders do not insist on receiving guarantees from the partners). One common structure involves the parties establishing a jointly owned UK company that borrows to acquire the UK target. Interest paid can offset the target's profits, while relief for any excess interest may be available to UK partners (or, in some circumstances, other 75 percent-owned UK subsidiaries of non-UK partners) by means of a consortium relief claim.

Choice of acquisition funding

A buyer using a UK acquisition vehicle to carry out an acquisition for cash needs to decide whether to fund the vehicle with debt, equity or a hybrid instrument that combines the characteristics of both. The principles underlying these approaches are discussed below.

Debt

The principal advantage of debt is the potential tax-deductibility of interest (see deductibility of interest), because the payment of a dividend does not give rise to a tax deduction. Another potential advantage of debt is the deductibility of expenses, such as guarantee fees or bank fees in computing trading profits for tax purposes. By contrast, the costs of a share issue are not deductible.

Where it is decided to use debt, it then must be decided which company should borrow and how the acquisition should be structured. To minimize the cost of debt, there must be sufficient taxable profits against which interest payments can be offset. The following comments assume that the buyer wishes to offset the interest payments against the UK target's taxable profits. Consideration should be given to whether relief would be available at a higher rate in another jurisdiction.

Typically, a UK company is used as the acquisition vehicle, funding the purchase with debt either from a related party (a debt pushdown) or directly from a bank. Provided at least 75 percent of the target's ordinary share capital is acquired (which, broadly, also entitles the holder to 75 percent economic ownership of the target), it should be possible to offset interest paid against UK taxable profits arising in the target group over the same period. Where interest cannot be offset immediately (i.e. there are insufficient taxable profits), the resulting losses can be carried forward and offset against future profits of the UK borrower or surrendered as group relief in subsequent periods, subject to a limit of 50 percent of taxable profits.

Depending on the existing structures of the buyer and target groups, it may also be possible to introduce debt into the UK after (rather than at the time of) the acquisition. Generally, this involves the acquisition by a debt-funded UK holding company of the newly acquired target's UK subsidiaries for cash consideration. The analysis of a post-acquisition debt pushdown can be complex. Specific anti-avoidance provisions may apply, such as the unallowable purpose rule, and local advice should be sought.

Deductibility of interest

Generally, a company's accounting treatment of interest is followed for tax purposes as long as it fairly represents all profits, gains and losses and all interest and expenses of the company's loan relationships. An accruals basis or mark-to-market basis is generally appropriate, and International Financial Reporting Standards (IFRS) and UK generally accepted accounting principles (GAAP) should meet these criteria. Where a company follows an accounting policy that does not satisfy these criteria, it is taxed on a basis that does meet these requirements.

Late-paid interest

An exception to the accruals treatment is that interest not paid within 12 months of the accounting period in which it accrues is deductible only when paid where the borrower is a 'close' company, the lender participates in the borrower or in a second company that controls the borrower, and the lender is resident in a territory with which the UK does not have a tax treaty that includes a non-discrimination clause.

Transfer pricing

UK transfer pricing legislation can restrict interest deductibility where the level of funding exceeds that which the company could have borrowed from an unrelated third party or where the interest rate charged is higher than an arm's length rate.

The UK transfer pricing rules apply when the parties to a transaction are under common control (or one of them controls the other). For financing arrangements, the scope of the rules is significantly wider and catches certain private equity structures. In principle, small and medium-sized enterprises are exempt (although the UK tax authorities may issue a direction to a medium-sized enterprise requiring it to apply the rules).

Transactions caught by the rules are required to meet the arm's length standard. Thus, payments of interest to an overseas (or UK) parent or overseas (or UK) affiliated company that represent an amount that would not have been payable in the absence of the relationship are not deductible for UK tax purposes. Where both parties to the transaction are subject to UK tax, it is normally possible for the party whose profits have been increased to claim a compensating adjustment, so that there is usually no impact on the cash tax payable by the group (although losses can become trapped in certain situations).

No specific debt-to-equity ratio or other test is included to assist in deciding whether the legislation applies. The tax authorities focus on the fundamentals of the business, including its position within the industry, and the commercial feasibility of the capital structure. Their guidance suggests that ratios of debt-to-earnings before interest, taxes, depreciation and amortization and interest cover are suitable measures of a company's arm's length capitalization.

Corporate interest restriction

The UK has enacted a new corporate interest restriction (CIR) that will potentially restrict corporation tax relief for finance costs as of 1 April 2017.

Any disallowance of interest-like expenses under the CIR rules must be calculated at the level of the 'worldwide group' for its 'period of account' and then allocated to individual UK tax-paying companies within the group.

A group will only suffer a disallowance to the extent that its 'aggregate net tax-interest expense' (ANTIE) (i.e. broadly, net tax-deductible interest-like expenses across the group) exceeds its 'interest capacity' for the period.

Subject to carry forward rules, the interest capacity is calculated as the lower of:

— 30 percent of the group's "aggregate tax-EBITDA", which is, broadly, the group's taxable earnings before relief for tax-interest expenses, capital allowances, intangibles amortization and certain other specific tax reliefs, and

— the group's 'adjusted net group-interest expense' (ANGIE), which is, broadly, the net finance cost recognized in profit and loss in the group's financial statements in respect of finance transactions, subject to certain adjustments.

However, a group is always allowed a minimum interest capacity of GBP2 million (on an annualized basis).

It is also possible for a group to make a 'group ratio election', under which the interest capacity for the period is calculated as the lower of:

— the group's 'qualifying net group-interest expense' (QNGIE), which is, broadly, the group's ANGIE excluding certain types of expenses (including related party finance costs), and

— the 'group ratio percentage' of the group's aggregate tax-EBITDA, which is defined as QNGIE divided by 'group EBITDA' (broadly, based on the group's profit before tax in its financial statements, subject to certain adjustments).

Where a group suffers a disallowance in a period of account, there are rules allowing the disallowed expense to be carried forward and reactivated in a subsequent period when the group has excess current-year interest capacity.

Where a group's current-year interest capacity exceeds its ANTIE for the period, there are rules allowing the excess to be carried forward to generate additional interest capacity in future periods.

Other debt-related issues

A number of other anti-avoidance provisions may also restrict interest deductibility. For example, interest may be re-characterized as a distribution where the return on the securities depends on the results of the company's business. Anti-avoidance legislation also combats certain structures that use hybrid entities and/or hybrid instruments to generate tax benefits (e.g. by creating a double dip).

Withholding tax on debt and methods to reduce or eliminate it

Payments of annual interest by a UK company to a non-resident are subject to WHT at 20 percent. The rate of WHT may be reduced or eliminated under a tax treaty or, where the recipient is a company resident in another EU member state, under the EU Interest and Royalties Directive.

In most cases, the terms of a tax treaty or the directive make it clear whether UK WHT would apply to payments of interest to companies in other EU member states.

The prior approval of the UK tax authorities must be obtained before the reduced rate can be applied. There is an exemption for payments to UK banks and UK branches of overseas banks. Where the lender would not qualify for an exemption from or a reduced rate of WHT, an intermediate company resident in a more favorable treaty territory may be preferred, or other structures or loan instruments that do not attract WHT may be considered.

Debt may be structured as either quoted Eurobonds or deep discount securities, which eliminates the obligation to WHT on interest.

Checklist for debt funding

— The use of bank debt may avoid thin capitalization and transfer pricing problems and should obviate the requirement to withhold tax from interest payments where debt is borrowed from UK banks.

— If interest cannot be offset on a current-year basis, it can be carried forward for offset against the future profits of the UK borrower or surrendered as group relief; in either case, offset is restricted to 50 percent of taxable profits.

— Consider whether the level of profits would enable tax relief for interest payments to be effective.

— It is possible that a tax deduction may be available at higher rates in other territories.

— WHT of 20 percent applies on interest payments to non-UK entities unless either a lower rate applies under the relevant tax treaty/EU directive and advance approval is obtained, or the debt is structured as a quoted Eurobond or deep discount security.

Equity

A buyer may use equity to fund its acquisition, possibly by issuing shares to the seller in satisfaction of the consideration or by raising funds through a seller placing. Further, the buyer may wish to capitalize the target post-acquisition.

The UK does not have any capital duty, and neither stamp duty nor SDRT generally applies to new share issues.

Under domestic law, there is no WHT on dividends paid by a UK company. Dividends are not deductible for UK tax purposes. Although equity offers less flexibility should the parent later wish to recover the funds it has injected, the use of equity may be more appropriate than debt in certain circumstances:

— Where the target is loss-making, it may not be possible to obtain immediate tax relief for interest payments.

— A number of restrictions on obtaining UK tax relief for interest may eliminate the principle advantage of using debt.

— Where the company is thinly capitalized, it would be disadvantageous to increase borrowings without also injecting fresh equity. A tax-efficient structure normally requires an appropriate mix of debt and equity.

— There may be non-tax grounds for preferring equity. For example, in certain circumstances, it may be desirable for a company to have a low debt-to-equity ratio. This factor is among those that may encourage the use of hybrid funding instruments (as discussed later in this report).

Tax-free reorganizations

Where an acquisition is effected by the purchase of shares in exchange for the issue to the seller of shares or loan stock in the buyer, the gain may be rolled over into the new shares or loan stock, thus enabling the seller to defer the UK capital gains tax liability. It is possible to obtain clearance in advance from the UK tax authorities that they will not deny the tax-free rollover under the relevant anti-avoidance provisions.

Hybrids

Hybrid financing — instruments treated as equity for accounts purposes by one party and as debt (giving rise to tax-deductible interest) by the other — generally ceased to be effective as of 1 January 2017 when legislation based on the recommendations in the OECD BEPS Action 2 report took effect.

Discounted securities

The tax treatment of securities issued at a discount to third parties normally follows the accounting treatment. As a result, the issuer should obtain a tax deduction for the discount accruing over the life of the security. However, where the borrower is a 'close' company, the lender participates in the borrower or in a second company that controls the borrower, and the lender is resident in a territory with which the UK does not have a tax treaty that includes a non-discrimination clause, a deduction for the discount accruing may be deferred until redemption. An advantage of discounted securities is that the discount does not give rise to WHT.

Deferred settlement

An acquisition often involves an element of deferred consideration, the amount of which can only be determined at a later date on the basis of the business' post-acquisition performance. The right to receive an unknown future amount is regarded as an asset that must be valued for UK tax purposes. This has potentially damaging consequences for a seller. The UK tax legislation that usually enables the seller in a paper-for-paper exchange to defer any capital gain until the subsequent disposal of the new shares does not apply to the right to an unknown future amount unless, when received, that amount will take the form of shares or loan stock. For corporate sellers, the receipt of such deferred consideration may be taxable.

Other considerations

Concerns of the seller

The tax position of the seller can be expected to significantly influence any transaction. In certain circumstances, the seller may prefer to realize part of the value of their investment as income by means of a pre-sale dividend. The rationale here is that the dividend may be subject to no or only a low effective rate of UK tax but reduces the proceeds of sale and thus the gain on the sale, which may be subject to a higher rate of tax. The position is not straightforward, however, because UK individuals are subject to a highest rate of tax on capital gains of 20 percent (the highest marginal rate of tax on dividends received by individuals is 38.1 percent). To defer capital gains charges, the seller may wish to receive share or loan note consideration. Each case must be examined on its facts.

The UK does not tax gains of non-residents (except certain disposals by non-resident companies with a permanent establishment in the UK).

Company law and accounting

The Companies Act 2006 prescribes how UK companies may be formed, operated, reorganized and dissolved. In some respects, UK company law allows considerable flexibility: the courts have a high degree of latitude, for example, in determining how companies may be reorganized. In other respects, the rules are relatively restrictive: corporate identity must be preserved so that, for example, the flexibility of reorganizations does not extend to allowing domestic mergers, although cross-border mergers with companies resident in other EU member states are permitted.

As for M&A, a business combination (which IFRS defines as the bringing together of separate entities or businesses into one reporting entity) may be categorized as either a merger or an acquisition. In essence, a combination is regarded as a merger where it effects a pooling of business interests (i.e. where one company's equity is exchanged for equity in another company) or shares in a newly incorporated company are issued to the merging companies' shareholders in exchange for the equity, with both sides receiving little or no consideration in the form of cash or other assets.

Company law and accounting standards predominantly determine the accounting treatment of a business combination. Generally, most combinations are accounted for as acquisitions, and merger accounting is only applied in limited circumstances. Merger accounting is not allowed under IFRS; all business combinations must be accounted for as acquisitions. The relevant UK accounting standards and company law restrict merger accounting to (and make it obligatory for) a very small number of genuine mergers and group reorganizations not involving minority interests.

Genuine mergers are those in which the shareholders come together in a partnership for the mutual sharing of the risks

and rewards of the combined entity and in which no party to the combination in substance obtains control over any other or is otherwise seen to be dominant in any way. Numerous detailed conditions must be met.

One of the main practical distinctions between acquisition accounting and merger accounting is that acquisition accounting may give rise to goodwill. The net assets acquired are brought onto the consolidated balance sheet at their fair values, and goodwill arises to the extent that the consideration given exceeds the aggregate of these values. As long as IFRS is not adopted or incorporated into UK GAAP, the goodwill is then amortized through the profit and loss account over its useful economic life. Acquisition accounting principles also apply to purchases of trade and assets and to any goodwill and fair value adjustments appearing on the acquirer's own balance sheet. In merger accounting, goodwill does not arise, as the acquirer and the seller are treated as though they had operated in combination since incorporation. Adjustments are made to the value of the acquired net assets only to the extent necessary to bring accounting policies into line.

Another important feature of UK company law concerns the ability to pay dividends. Distributions of profit may be made only out of a company's distributable reserves. For groups, this means the reserves retained by the holding company (or its subsidiaries) rather than those of the group at the consolidated level. Regardless of whether acquisition or merger accounting is adopted in the group accounts, the ability to distribute the pre-acquisition profits of the acquired company may be restricted. In certain types of business combination, legal provisions referred to as merger relief (not to be confused with merger accounting) may apply, which allow shares received as consideration to be recorded at their nominal amounts. These provisions may remove or decrease the restrictions on the ability to make distributions. IFRS does not allow merger relief because it requires the cost of acquisition to be recorded at fair value.

Finally, a common issue on transaction structuring arises from the provisions concerning financial assistance. Broadly, these rules make it unlawful for a public company (or one of its private subsidiaries) to give financial assistance, directly or indirectly, for the purpose of acquiring the public company's shares.

It is also unlawful for a public company that is a subsidiary of a private company to give financial assistance, directly or indirectly, for the purpose of acquiring that private company's shares. Financial assistance is broadly defined. Unlawful financial assistance is a criminal offence and renders the transaction involved unenforceable.

Group relief/consolidation

Where the buyer owns other UK companies, the target company is included in a UK tax group so that UK profits and losses can be effectively consolidated for tax purposes.

Where the buyer does not wish to acquire the entire share capital of the target, group relief should still be available, provided the buyer owns at least 75 percent of the ordinary share capital, which generally also entitles it to 75 percent economic ownership of the target.

Transfer pricing

Where an intercompany balance arises between the buyer and the target following the acquisition, failure to charge interest on the balance may create transfer pricing problems in the relevant jurisdiction. For example, where the balance is owed to the target, the UK tax authorities could impute interest on the balance where an arm's length interest rate is not charged.

Dual residency

There are few advantages in establishing a dual resident company. The losses of a dual resident investing company cannot be offset against profits of other UK companies.

Foreign investments of a local target company

The profits of a controlled foreign company (CFC) escape UK tax altogether where the CFC is resident and carrying on business in certain excluded territories, pays tax on its profits equivalent to at least 75 percent of the corresponding UK tax, has only come under control of a UK resident company within the last 12 months, or has profits of less than GBP50,000 or a profit margin of less than 10 percent.

Where none of these conditions are met, only those profits of the CFC that pass through the CFC 'gateway' are subject to UK tax. These include profits attributable to UK activities, non-trading finance profits (with partial or full exemption available for group finance companies), trading finance profits and profits from captive insurance business. In each case, particular rules apply to determine whether and how much of the profits concerned pass through the 'gateway'. Specialist advice should be sought.

The CFC rules include a partial exemption regime for finance companies. Only 25 percent of such a company's chargeable profits is subject to UK tax.

Although they are referred to as a finance company regime, the new rules apply to both pure finance companies and mixed companies. There is no debt-to-equity ratio requirement, and the substance requirement is limited to the maintenance of premises in the company's territory of residence. The partial exemption is, however, limited to income from loan relationships excluding upstream loans to the UK and is currently the subject of an EU state aid challenge.

Comparison of asset and share purchases

Advantages of asset purchases

— The purchase price (or a proportion) can be depreciated or amortized for tax purposes (excluding goodwill).

— A step-up in the cost base of assets for capital gains purposes is obtained.

— A deduction is gained for trading stock purchased.

— No previous liabilities of the company are inherited.

— Possible to acquire only part of a business.

— Possible for the seller to rollover gains into the cost of acquiring other assets.

Disadvantages of asset purchases

— May need to renegotiate supply, employment and technology agreements, etc.

— Higher capital outlay is usually involved (unless debts of the business are also assumed).

— May be unattractive to the seller, especially where a share sale would be exempt, thereby increasing the price.

— Higher transfer duties usually arise.

— Accounting profits may be affected by the creation of acquisition goodwill.

— Benefit of any losses incurred by the target company remains with the seller (or may be lost altogether).

Advantages of share purchases

— There is usually a lower capital outlay (purchase of net assets only).

— Likely to be more attractive to the seller, both commercially and from a tax perspective (because the disposal may be exempt), so the price may be lower.

— Buyer may benefit from tax losses of the target company.

— Buyer may gain the benefit of existing supply and technology contracts.

— Lower transfer duties are usually payable.

Disadvantages of share purchases

— Buyer acquires unrealized tax liability for depreciation recovery on the difference between accounting and tax book value of assets.

— Buyer effectively becomes liable for any claims or previous liabilities of the entity (including tax).

— No deduction is available for the purchase price.

— Possibly more difficult to finance tax-efficiently.

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Canada

Introduction

Although not defined by statute, the phrase 'mergers and acquisitions' (M&A) is used in Canada to describe combinations of business enterprises by means of an acquisition or other combination technique, such as an amalgamation, that is allowed under applicable corporate law. A merger or acquisition involving shares of a Canadian company or its assets can be completed in a number of ways, depending on the type of consideration to be paid, tax and financing considerations, as well as corporate law and regulatory issues.

The M&A market in Canada has improved over the last 2 years. Since the last edition of this report, tax developments relating to M&A have been limited, with most changes aimed at preventing what the tax authorities have perceived as abusive tax planning.

This report begins with an overview of recent developments in the Canadian tax environment for M&A and then addresses the principal issues that face prospective buyers of Canadian companies and their assets.

Recent developments

Treaty shopping and base erosion and profit shifting

On 7 June 2017, Canada signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (multilateral instrument — MLI) promulgated by the Organisation for Economic Co-operation and Development (OECD). In executing the MLI, Canada listed the majority of its existing tax treaties as 'covered tax agreements' that would be subject to the MLI's terms. For certain other tax treaties, Canada has indicated that it would consider implementing certain measures through bilateral negotiations with those countries.

Regarding the treaty-shopping provisions, Canada has indicated that it would adopt the principal purpose test (PPT) when determining whether an entity could benefit from the tax treaty, while seeking to add limitation of benefit (LOB) provisions through bilateral negotiations. The MLI is expected to take effect in 2019, although the Department of Finance has not yet released draft enabling legislation.

Asset purchase or share purchase

An acquisition of a business may take many different forms. The most common way is the purchase of assets or shares. There are many significant differences in the tax implications of an acquisition of assets versus shares. The choice largely depends on the buyer's and seller's tax positions and preferences.

Typically, a seller would prefer to sell shares, since it would expect capital gains treatment on the sale (50 percent inclusion rate for tax purposes) and may be entitled to a capital gains exemption. By contrast, a sale of assets could result in additional tax from recapture of capital cost allowances (tax depreciation) and double taxation of sale proceeds when they are extracted from the corporation.

A buyer would typically prefer to acquire assets, since the tax cost of the assets would be stepped up to fair market value, resulting in a higher tax shield, as opposed to inheriting the historical tax shield.

The following sections discuss in more detail some of the major income tax issues that should be reviewed when considering a purchase of assets or shares. Other non-tax issues should also be considered.

In addition, the last section of this report summarizes certain advantages and disadvantages of an asset versus share purchase.

Purchase of assets

An asset purchase generally results in an increase to fair market value in the cost basis of the acquired assets for capital gains tax and depreciation purposes, although this increase is likely to be taxable to the seller. Further, an asset purchase enables a buyer to avoid assuming the seller's tax liabilities and historical attributes in respect of the assets.

Purchase price allocation

A purchase and sale agreement relating to the acquisition of business assets usually includes a specific allocation of the purchase price between the various assets acquired. To the

extent that the acquisition is between arm's length parties, the Canada Revenue Agency (CRA) generally accepts the purchase price allocation as set out in the purchase and sales agreement. However, where one party to the transaction does not have a vested interest in the allocation of the purchase price, the CRA may seek to adjust the allocation if it believes that it does not reflect the relative fair market values of the assets.

In the case of transfers between non-arm's length parties, the transaction is deemed to take place at fair market value for Canadian tax purposes. In reviewing such transactions, the CRA would be concerned that the aggregate purchase price and the allocation of the price to specific assets are in accordance with the related fair market values. To avoid possible adverse reassessments, a price adjustment clause is often used in non-arm's length transactions to ensure that any adjustment of the sale price is also reflected in an adjustment of the purchase price. Such a clause may purport to provide for retroactive adjustments to the purchase price if the CRA successfully challenges the fair market value or the related allocations.

Depreciation

The cost of most tangible and intangible assets acquired, other than land but including goodwill, can be depreciated for Canadian tax purposes. Each type of property acquired must be included in a particular class of assets for capital cost allowance purposes. The rates of depreciation, which vary by class, are generally intended to be indicative of the useful lives of the assets included in the specific class. Rates for some of the more common classes of assets are as follows:

Type of asset	Depreciation rate
Buildings	4 percent declining-balance
General machinery, equipment, furniture and fixtures	20 percent declining-balance
Motor vehicles	30 percent declining-balance
Manufacturing and processing equipment	30 percent declining-balance or 50 percent straight-line[1]
Computers and software	100 percent
Goodwill (and other indefinite life intangibles)	5 percent declining-balance

Source: KPMG in Canada, 2018

Tax depreciation is usually calculated on a declining-balance basis by multiplying the depreciation rate by the closing balance in the account (essentially, cost less accumulated depreciation and sale proceeds). The amount of depreciation that can be claimed in the year that assets are acquired is generally limited to 50 percent of the amount otherwise determined. In addition, the amount of depreciation otherwise available is prorated for a short taxation year.

On a disposal of depreciable property, any amounts previously deducted as depreciation could be recaptured and included in income when the closing balance of the account becomes negative. Additionally, any proceeds realized over the original cost are treated as a capital gain that is included in income at a 50 percent inclusion rate.

The cost of intangible assets with a limited life may also be depreciated for tax purposes. For example, the cost of licenses, franchises and concessions may be depreciated over the life of the asset. Patents or a right to use patented information for a limited or unlimited period may be depreciated on a 25 percent declining-balance basis. Alternatively, limited life patents can be depreciated over the life of the asset. Premiums paid to acquire leases or the cost of leasehold improvements are generally deducted over the life of the lease. Most other intangible assets, including goodwill and other business-related capital expenditures, are pooled and added to a class that may be depreciated at 5 percent annually, also on a declining-balance basis.

Tax attributes

On a sale of assets, any existing losses remain with the corporate seller and generally may be used by the seller to offset capital gains or income realized on the asset sale. Likewise, a seller's depreciation pools are not transferred to the buyer on an asset acquisition.

Indirect taxes (value added tax and provincial sales tax)

Canada has a federal valued added tax (VAT) known as the goods and services tax (GST). GST is a 5 percent tax levied on the supply of most goods and services in Canada. Five participating provinces (Ontario, Prince Edward Island, Nova Scotia, New Brunswick and Newfoundland) have harmonized their provincial sales taxes (PST) with GST to create the harmonized sales tax (HST). HST generally applies to the same base of goods and services as GST, but at rates of between 13 and 15 percent for supplies made in the harmonized provinces (the rate depends on the province in which the supply is made). Quebec also has a VAT, called Quebec Sales Tax (QST), which is similar but not identical to the GST and HST. The QST rate is 9.975 percent. Three provinces (British Columbia, Manitoba and Saskatchewan) impose PST on goods and certain services at the rate of between 5 and 8 percent.

The sale of business assets by a registered person constitutes a supply of goods for GST/HST purposes and, as a general rule, the tax would have to be collected. However, where a registered person makes a supply of a business or part

[1] The 50 percent rate applies to M&P equipment acquired before 2016. Certain requirements must be satisfied for the 30 percent rate.

of a business and the recipient is a GST/HST registrant and is acquiring all or substantially all of the property that can reasonably be regarded as being necessary to carry on the business or part of the business, no GST/HST is charged on the purchase price, provided a joint election is made. As long as the assets sold are part of a going concern of the seller that will continue to be carried on commercially by the buyer, this relieving provision should apply. Where the relieving provision does not apply, the tax is charged based on the consideration for the assets sold. However, not all assets are subject to GST/ HST (e.g. sale of accounts receivable) and special rules apply to real property and to related-party transactions.

Where GST/HST does apply, the buyer should be able to recover the tax paid to the seller through a refund mechanism called an 'input tax credit', provided the buyer is registered for GST/HST at the time the assets are deemed to have been supplied and the buyer is using the assets in its commercial activities.

The sale of tangible assets located in a PST province may be subject to PST depending on the type and/or use of the tangible asset. Other PST-related obligations may apply on the transfer of tangible assets (such as clearance certificates). Generally, PST is a non-recoverable tax.

Transfer taxes

Most of the provinces impose land transfer taxes on transfers of real property: land, buildings and other improvements. In Ontario, the transfer of interests in partnerships that hold real property can also attract land transfer tax. The rates of land transfer tax vary by province and range from 0.25 to 2 percent of the consideration for the real property transferred. Certain exemptions from land transfer taxes apply to non-arm's length transactions (non-arm's length exemption). No stamp or transfer duties are generally payable on the transfer of shares. Some of the provinces may impose land transfer tax if a transfer of shares occurs within a certain period after the transfer of real property that was eligible for a non-arm's length exemption.

Purchase of shares

The following sections discuss some issues that should be considered when acquiring a target company's shares.

Tax indemnities and warranties

A buyer of a target company's shares assumes the historic tax liabilities of target. Therefore, the purchase and sale agreement for the share usually contains representations and warranties regarding the tax status of the target company, the breach of which gives rise to indemnification by the seller. Whether the indemnity is subject to any cap or basket usually forms part of the business negotiation. Given the historic tax liabilities that may carry over to the buyer on a sale of shares, it is customary for the buyer to initiate a tax due diligence process that would incorporate a review of the target's tax affairs, notwithstanding that the seller may provide indemnities and warranties.

In a public company takeover, the target company may allow the buyer a suitable due diligence period and make available to the buyer most financial and corporate information. Typically, this due diligence process would include an in-depth review of the tax affairs of the target company by the advisors of the buyer.

In a hostile takeover of a public company, a due diligence review normally would not be carried out.

Ability to step-up tax cost

On an acquisition of assets, the total purchase price is allocated to the specific assets acquired, based on their respective fair market value, as negotiated by the parties. Depending on the allocation, a step-up in the tax basis of the acquired assets is available. On an acquisition of shares, there is generally no increase in the tax basis of the assets of the target company and no goodwill is recognized for tax purposes.

The tax basis of certain non-depreciable capital properties owned by the target company can be increased if the target company is amalgamated with or wound up into the Canadian acquisition company. This is often referred to as a 'bump'. Properties eligible for the bump include shares of subsidiaries of the target company, partnership interests (to the extent of accrued gains on underlying capital property) and land.

The bump cannot exceed the fair market value of the eligible property at the time the target company was acquired. The total bump is limited to the excess of the purchase price of the shares of the target company over the net tax cost of the assets of the target company. Additionally, the bump room on shares of foreign affiliates is subject to specific limitations based on the tax-free surplus balances of the foreign affiliates. Accordingly, taxpayers need to calculate the surplus balances of foreign affiliates of the Canadian target entity and make appropriate tax elections to utilize the surplus balances to reduce the proceeds received. Under an administrative position, the CRA will not challenge surplus calculations (or the lack thereof) of foreign affiliates that are moved out from under Canada within a reasonable time if certain other conditions are met. Accordingly, in certain cases, it may not be necessary to conduct surplus calculations.

The bump rules are extremely complex, and careful planning is required to ensure the bump will be available. In certain cases, obtaining a bump is a critical aspect of the transaction.

For example, the target company may operate three lines of business through three subsidiaries. If the non-resident buyer only desires to acquire and operate two of the businesses, a bump may be desirable to minimize the taxes on the sale of the non-desired assets.

Typically, to structure a bump, a Canadian acquisition company could acquire the target company, after which the target would be wound up into or merged with the Canadian acquisition company. The tax basis of the shares of the subsidiary operating the unwanted business could be bumped to their fair market value (subject to the restrictions described earlier) and sold to a third party without income tax consequences (if the bump is available).

When a bump is to be obtained on the tax basis of the assets of the target, the buyer may request representations or covenants from the seller that it has not and will not enter transactions that could adversely affect the bump.

Tax losses

A Canadian company may carry forward two primary types of losses: net capital losses and non-capital (or business) losses. Capital losses are incurred on the disposal of capital property. Half of such losses must be deducted against the taxable portion of capital gains (50 percent) realized in the year, with any excess loss being available for carry forward or back as a net capital loss. Net capital losses may be carried back 3 years or forward indefinitely, but they may only be used to reduce taxable capital gains in these periods. Non-capital losses (NOL) are generally business or property losses that may be carried back 3 years or forward 20 years and generally applied against income from any source.

On a sale of assets, any existing losses remain with the corporate seller, which can generally use them to offset any capital gains or income realized on the asset sale.

On a share sale that results in an acquisition of control of the target corporation, a deemed tax year-end is triggered immediately before the acquisition. A number of specific rules determine the carry forward and use of pre-acquisition losses, as discussed below. Generally, accrued capital losses on capital assets of the corporation are deemed realized, which results in a write-down of capital property to its fair market value. Net capital losses may not be carried forward after an acquisition of control, so planning should be undertaken to utilize such losses if possible.

On an acquisition of control, accrued terminal losses on depreciable properties are deemed realized and bad debts must be written-off. These deductions from income in the taxation period that ends at the time of the acquisition of control may increase the target corporation's non-capital losses. Non-capital losses are only deductible following an acquisition of control within the carry forward period if certain requirements are met. Non-capital losses from carrying on a business may be deductible after the acquisition of control if the business that sustained the losses continues to be carried on with a reasonable expectation of profit. However, such losses are deductible only to the extent of the corporation's income from the loss business or similar businesses. Similarly, on a liquidation of an acquired company or the amalgamation of the acquired company with its parent, the pre-acquisition non-capital losses are deductible by the parent but only against income from the business of the acquired corporation in which the losses arose or from a similar business.

Non-capital losses that do not arise from carrying on a business (referred to as 'property losses') cannot be used after an acquisition of control. Thus, planning should be undertaken to utilize such losses if possible.

Despite the above-noted rules, the target company may elect to trigger accrued gains on depreciable and non-depreciable capital property to offset any net capital or non-capital losses either carried forward or deemed realized on the acquisition of control that would otherwise expire. The general effect of these rules is to allow a corporation, before the change of control, to convert net capital losses or non-capital losses existing or accrued at that time into a higher cost base for capital assets that have current values that exceed their tax basis.

Pre-sale dividend

In certain cases, the seller may prefer to realize part of the value of their investment as income by means of a pre-sale dividend and hence reduce the proceeds of sale. This planning may be subject to anti-avoidance rules. If the rules apply, the dividend is deemed to be proceeds of disposal and thus give rise to a capital gain rather than a dividend. However, if the dividend can be attributed to 'safe income on hand' (generally, retained earnings already subjected to tax), these anti-avoidance rules should not apply. The scope of these anti-avoidance rules has been significantly expanded in recent years.

Transfer taxes

No stamp or indirect taxes are payable on a transfer of shares.

However, for an asset sale, most provinces impose land transfer taxes on transfers of real property (e.g. land, buildings, improvements), and sales taxes (e.g. PST, GST, HST) may apply.

Tax clearances

The CRA does not give clearance certificates confirming whether a potential target company has any arrears of tax owing or is involved in any audit or dispute relating to prior audits. It is recommended that comprehensive tax due diligence be performed on a Canadian target corporation.

Clearance from the tax authorities is not required for a merger or acquisition except in certain circumstances where the seller is a non-resident. Where a non-resident disposes of

taxable Canadian property, the seller may have obligations under section 116 of the Income Tax Act.

Taxable Canadian property includes:

— Canadian real property

— assets used in carrying on business in Canada

— Canadian private company shares that derive more than 50 percent of their value from certain Canadian property

— shares of Canadian public companies where certain ownership thresholds are satisfied and which primarily derive their value from taxable Canadian property.

Unless the disposed taxable Canadian property is a 'treaty-protected property' and the buyer provides the requisite notice to the CRA, a buyer is required to remit funds to the CRA equal to a portion of the purchase price (25 or 50 percent), unless the non-resident seller provides an appropriate clearance certificate. As the buyer is entitled to withhold from the purchase price in order to fund its remittance obligation, it is important to deal with these issues in the legal documentation.

In addition to any clearance certificate compliance obligations, a non-resident seller is also required to file a Canadian tax return reporting the disposition (subject to certain exceptions for treaty-exempt property).

Choice of acquisition vehicle

Several potential acquisition vehicles are available to a foreign buyer. Tax factors often influence the choice. The following vehicles may be used to acquire either the shares or assets of a Canadian target company.

Local holding company

The use of a Canadian acquisition company to acquire either assets or shares of a Canadian target company is common.

A Canadian acquisition company is often used when a non-resident acquires shares of a Canadian target corporation. On a share acquisition, the use of a Canadian acquisition company may be advantageous for financing the acquisition or for deferring Canadian WHT on distributions in the form of a return of paid-up capital (as discussed below). In addition, a deferral of WHT can be achieved where there are minority Canadian shareholders of the acquired company (e.g. employees, public shareholders) and dividends are paid on a regular basis. The foreign parent may not require its share of the dividends to be repatriated and can defer Canadian WHT by using a Canadian holding company.

A return of paid-up capital (generally, the amount for which the shares were originally issued to the original holder) is not subject to income tax or WHT. Therefore, if a non-resident acquires a Canadian target company directly, the amount paid to acquire the shares of the target company can only be returned to the non-resident free of WHT to the extent of any existing paid-up capital. If the non-resident incorporates a Canadian acquisition company, the tax basis and paid-up capital of the shares of the acquisition company should both be equal to the purchase price (assuming no debt financing). The paid-up capital of the acquisition company can be repatriated to the non-resident parent free of Canadian WHT.

After the share purchase, the Canadian acquisition company and the target company may be amalgamated (i.e. merged; see discussion under company law). An amalgamation of the two entities will be useful for debt financing (to 'push down' the interest expense against the operating assets), since Canada does not have tax-consolidation.

An amalgamation of the acquisition and target companies results in deemed year-ends immediately before the amalgamation for both companies. As discussed later in this report, a deemed year-end also occurs when control of a company is acquired. To potentially avoid extra year-ends, the amalgamation could be effected on the same day as the share acquisition so the deemed year-ends coincide (depending on all relevant transactions).

Foreign parent company

The foreign parent company may choose to make the acquisition directly, perhaps to shelter its own taxable profits with the financing costs (at the parent level), but there are two main disadvantages to this approach:

— The parent inherits the historical paid-up capital instead of having a paid-up capital equal to the purchase price. In some cases, historical paid-up capital could exceed the purchase price, for example, where the target corporation has declined in value.

— It would be more difficult to push debt into Canada or leverage Canada.

As discussed earlier in this report, paid-up capital is advantageous from a Canadian tax perspective when a distribution is made through a return of capital, since it does not attract Canadian WHT. Therefore, an intermediary holding company resident in a favorable treaty country is preferable to a foreign parent company from a Canadian tax perspective.

Non-resident intermediate holding company

A treaty country intermediary shareholder may be advantageous in certain cases, depending on the jurisdiction of incorporation of the non-resident buyer. Canada has an extensive tax treaty network. The treaty WHT rates vary from 5 to 25 percent on dividends and from 0 to 15 percent on interest (see this report's discussion on WHT on debt.) The domestic Canadian withholding rate is 25 percent for non-treaty countries.

Some treaties provide greater protection against Canadian capital gains tax on the disposal of shares of a Canadian

company than the normal Canadian taxation rules that apply to disposals by non-residents. As a result, the use of a treaty country intermediary to make the acquisition may be useful in certain circumstances. As with all international tax planning, it is necessary to consider treaty-shopping provisions in the treaties, substance requirements and domestic anti-avoidance rules.

On 7 June 2017, Canada signed the OECD's MLI , saying Canada would adopt the PPT and seek to add LOB provisions through bilateral negotiations (for details, see 'Recent developments'). These additional conditions will need to be considered in the context of any acquisition involving a non-resident buyer.

Local branch

The use of a branch to acquire assets of a target company yields similar results to forming a Canadian company, assuming the acquisition creates a permanent establishment in Canada. The rate of federal and provincial income tax is approximately the same for a branch as for a Canadian corporation. In addition, a branch tax generally is imposed on profits derived by non-resident corporations from carrying on business in Canada and not reinvested in Canada. The branch tax parallels the dividend WHT that would be paid if the Canadian business were carried on in a Canadian corporation and profits were repatriated by paying dividends to its non-resident parent. Accordingly, the branch tax base is generally intended to approximate the after-tax Canadian earnings that are not reinvested in the Canadian business.

However, in the case of a Canadian subsidiary, the timing of distributions subject to WHT can be controlled, but branch tax is exigible on an annual basis. Some of Canada's tax treaties provide an exemption from branch tax on a fixed amount of accumulated income (e.g. CAD500,000).

In certain cases, it is advantageous for a non-resident corporation starting a business in Canada initially to carry on business as a branch, because of the ability to use start-up losses against the non-resident parent's domestic income or the availability of a partial treaty exemption from branch tax. Subsequently, the branch can be incorporated and a tax rollover may be available.

Joint venture

Where an acquisition is made in conjunction with another foreign or domestic party, a special-purpose vehicle, such as a partnership or joint venture, may be considered. However, the use of such a vehicle still requires fundamental decisions as to whether the participant in the partnership or joint venture should be a branch of the foreign corporation or a Canadian subsidiary and whether a treaty country intermediary should be used.

Incorporation offers the advantages of limited liability by virtue of a separate legal existence of the corporate entity from its members. A limited partnership may offer similar protection, but a limited partner cannot participate in the management of the partnership. A general partnership results in the joint and several liability of each partner for all of the partnership liabilities, although limited liability protection can be offered by using a single-purpose domestic corporation to act as partner.

The primary advantage of using joint ventures or partnerships to make acquisitions with other parties is that losses realized by a joint venture or a partnership are included in the taxable income calculation of the joint venturers or partners. In contrast, corporate tax-consolidation is not permitted for Canadian tax purposes, so losses incurred by a corporate entity must be used by that entity and generally can only be transferred to another Canadian company in the group on liquidation, amalgamation or, potentially, through a complex loss-utilization transaction.

Choice of acquisition funding

A buyer using a Canadian acquisition vehicle to carry out an acquisition for cash needs to decide whether to fund the vehicle with debt, equity or a hybrid instrument that combines the characteristics of both. The principles underlying these approaches are discussed below.

Debt

The principal advantage of acquiring shares of a corporation through debt financing is the potential tax-deductibility of interest (and other related financing fees). The combined federal and provincial corporate tax rates in Canada may be higher than in some other countries. As a result, it may be desirable to have financing costs relating to Canadian acquisitions deductible in Canada against income that would otherwise be taxable at the Canadian rates and subject to Canadian WHT on repatriation. Since there is no tax-consolidation, it is important that any financing costs be incurred by the entity that is generating income.

The Canadian rules relating to interest deductibility generally permit a buyer to obtain a deduction for interest expense on acquisition debt. Interest on money borrowed by a Canadian acquisition company to acquire the shares of a target company is generally fully deductible. However, the acquisition company may not have sufficient income against which the interest expense can be deducted, which could result in unused interest deductions. To the extent that the target company is subsequently liquidated into or amalgamated with the acquisition company, the interest on the acquisition debt should be deductible against the profits generated by the business of the target company.

The main restriction on acquisition debt funding obtained from a non-resident related party is in the thin capitalization rules. Interest on the portion of debt owed by a Canadian corporation (target company) to certain non-residents that

exceeds 1.5 times the shareholder's equity of the Canadian target company is not deductible. The interest that relates to the portion of the debt below the 1.5:1 debt-to-equity threshold is generally deductible. Interest that relates to the portion of the debt above the 1.5:1 debt-to-equity threshold is treated as a deemed dividend subject to WHT.

The thin capitalization rules apply if the shareholder is a specified shareholder, which includes non-resident shareholders and other related parties who together own at least 25 percent of the voting shares or 25 percent of the fair market value of all the shares in the company.

Deductibility of interest

Canada has rigid interest deductibility rules — interest expense is not automatically deductible. Interest is deductible for Canadian tax purposes if it is paid pursuant to a legal obligation to pay interest and relates to:

— borrowed money used to earn income, or

— an amount payable for property acquired for the purpose of earning income.

In computing business income, accrued interest is generally fully deductible for tax purposes, although compound interest is only deductible when paid. Some financing fees are generally deductible over 5 years for tax purposes while others must be capitalized and amortized at a rate of 5 percent per year on a declining basis.

Where shares of a company are redeemed for a value in excess of paid-up capital and retained earnings, or dividends are paid in excess of retained earnings, interest expense incurred to fund such redemptions or dividends may not be tax-deductible.

Interest-free loans made between Canadian corporations generally do not give rise to any adverse tax consequences. Similarly, interest-free loans made by a non-resident shareholder to a Canadian company generally do not give rise to adverse Canadian tax consequences. However, in the case of interest-free loans made by a Canadian company to a related non-resident that remain outstanding for more than 1 year, interest income will be imputed to the Canadian company, subject to certain exceptions. Further, such a loan to a non-resident shareholder is treated as a dividend to the non-resident shareholder and subject to WHT if outstanding for more than 1 full taxation year. The non-resident shareholder may be permitted to claim a refund of the WHT paid when the interest-free loan is repaid, provided the repayment is not part of a series of loans or other transactions and repayments.

Withholding tax on debt and methods to reduce or eliminate it

Interest paid by a Canadian resident corporation to a non-arm's length non-resident lender is subject to WHT. The domestic rate of withholding is 25 percent. However, the rate is generally reduced under Canada's tax treaties to 10 or 15 percent. Under the Canada-US tax treaty, the rate could be reduced to 0 percent if the recipient qualifies for treaty benefits.

WHT does not apply to non-participating interest paid to an arm's length, non-resident lender. WHT also generally does not apply where the non-resident lender receives the interest in connection with a fixed place of business in Canada, in which case the lender would be subject to normal Canadian income tax.

Because Canadian WHT applies only at the time of payment or crediting, WHT can be deferred to the extent that interest is not actually paid or credited. However, interest that is accrued by a Canadian-resident taxpayer and owed to a non-arm's length, non-resident is not deductible by the Canadian-resident corporation if payment is not made within 2 years from the end of the taxation year in which the interest accrued.

Checklist for debt funding

— The use of bank debt may be advantageous for several reasons: no thin capitalization rules, no transfer pricing problems on the interest rate, and no WHT on interest payments.

— If the debt is funded from a related party, consider whether the 1.5:1 debt-to equity thin capitalization restrictions apply. WHT may apply on the interest paid.

— Consider whether the level of profits will enable tax relief for interest payments to be effective.

— Consider whether interest-free loans would have interest imputed if loans from a Canadian corporation to a non-resident are outstanding for more than 1 year.

— Consider whether a deemed dividend exists when loans from a Canadian corporation to a non-resident remain outstanding for more than a year.

— Consider whether there is an income inclusion to the Canadian corporation on upstream loans made by its foreign affiliates.

— If the debt borrowed by the Canadian target company to redeem shares exceeds paid-up capital and retained earnings or dividends are paid in excess of retained earnings, interest expense incurred to fund the excess amounts relating to such distributions may not be tax-deductible.

— Consider whether transfer pricing principles could apply to interest rates charged on related-party debts.

— Consider whether there are cash flow issues and whether interest payments made on related party debt may be deferred for 2 years.

Equity

A buyer may use equity to fund its acquisition. The amount of equity depends on the buyer's preference. Canada does not have any stamp duties.

Dividends paid by a Canadian company to a corporate shareholder resident in Canada generally are not subject to income tax for the recipient or WHT for the payer, although a refundable tax applies to private companies receiving dividends on portfolio investments. Special rules may apply to dividends paid on preferred shares, in which case there is a form of advance corporation tax (discussed later). Payments of dividends are not deductible by the payer for income tax purposes.

Canadian tax rules permit deferred transfers and amalgamations where certain conditions are met. Some commonly used tax-deferred reorganizations and mergers provisions are as follows:

- A transfer of assets to a corporation results in a taxable disposition of the assets at fair market value. However, if the transferor and transferee make a joint election, potentially all or a portion of a gain on the transfer of eligible assets can be deferred. This election permits a tax-deferred transfer or rollover of property to a taxable Canadian corporation as long as the transferor receives shares as part of the consideration for the transfer. The adjusted cost base of the shares they receive should equal the adjusted cost base of the assets transferred (assuming no non-share consideration is received). The deferred income or capital gain arises only when the shares are sold in an arm's length transaction. However, double taxation is inherent in the rollover since the transferee corporation also inherits the adjusted base of the assets received as its adjusted base of those assets.
- A similar election is available for a transfer of assets to a partnership.
- A rollover is also available for a shareholder of a corporation who exchanges:
  - shares of a corporation for shares of the corporation or exercises a conversion right to convert debt into shares of a corporation (no election required)
  - shares of one taxable Canadian corporation for shares of another taxable Canadian corporation (no election required); this provision is most often used in a takeover where arm's length shareholders of one corporation exchanges shares for shares of the purchasing corporation.

The section of the Income Tax Act governing the rollover prescribes, among other things, the type of property eligible for transfer, whether the transferor can receive anything other than shares in return and whether an election is required.

In the event of an amalgamation (merger) of two Canadian taxable corporations, a tax-deferred rollover may be available in which no immediate tax implications should arise for the corporations and their shareholders, provided certain conditions are met. If all the conditions are met, the rollover provision should apply automatically without an election.

While the amalgamation generally should rollover the principal tax attributes of the predecessor corporations to the amalgamated entity, each predecessor corporation will experience a deemed year-end immediately before the amalgamation. The deemed year-end will age by 1 year any loss carry forwards. Other provisions related to the timing of a year-end should be considered, including the proration of amounts in a short taxation year. This tax-deferred rollover generally allows the corporations and shareholder to be in a tax-neutral position.

If the merger is a vertical amalgamation (between a parent and its wholly owned subsidiary), two additional planning opportunities may be available: utilization of post-amalgamation losses to recover taxes paid by the predecessor parent and access to the 'bump' (as discussed earlier), subject to certain conditions.

A tax-deferred wind-up is also available if certain conditions are met (i.e. the subsidiary must be a taxable Canadian corporation of which at least 90 percent of each class of shares is owned by another Canadian taxable corporation). This tax-deferred wind-up is similar to the tax-deferred amalgamation except there is no deemed year-end.

Hybrids

The Canadian tax treatment of a financial security, either as a share or as a debt obligation, is largely determined by the legal form of the security as established by the applicable corporate law. A dividend payment on a share is generally treated as a dividend regardless of the nature of the share (i.e. common or preferred). An interest payment on a debt obligation is generally considered to be interest for tax purposes, although its tax-deductibility may be limited.

The Canadian tax authorities generally characterize a financial security issued by a foreign corporation as either debt or equity in accordance with the corporate law of the jurisdiction in which the security is issued, having regard to Canadian commercial law principles. The tax treatment of the security in the foreign jurisdiction, however, is irrelevant when it is inconsistent with the characterization under the relevant Canadian corporate law.

Discounted securities

If a company has issued a debt security at a discount and pays an amount in satisfaction of the debt security that exceeds proceeds received by the company on the issuance of security, the company may deduct all or a specified portion of the excess in certain circumstances.

Deferred settlement

To the extent that all or a portion of the purchase price is represented by debt that is not due to the seller until after the end of the year, a reserve may be available to defer a portion of the gain that is taxable to the seller. For disposals of shares, the reserve is limited to 5 years. At least one-fifth of the gain must be included in the seller's income in each year of disposal and the immediately following 4 years. For capital gains arising from a sale of assets, the same type of reserve is available to the extent that a portion of the consideration relating to capital property is not due to the seller until after the end of the year. This reserve is not available for recaptured depreciation. For non-capital property, a 3-year reserve on the portion of the profit from the sale relating to proceeds not yet payable may be available. Reserves on certain disposals of property among related parties could be denied.

Other considerations

Concerns of the seller

Sale of assets

In an asset sale, a main concern of the seller is the possible recapture of depreciation if depreciable assets are sold for more than their tax values. As discussed earlier, only 50 percent of the gain on goodwill and other non-depreciable capital properties may be included in income. (However, a company may have previously amortized purchased goodwill or intangibles, in which case recapture would arise.) Therefore, the seller will be concerned with the relative allocation of the purchase price to minimize the recovery of depreciation compared with the gains from capital property or goodwill.

PST and GST/HST are generally collectible by the seller from the buyer on an asset sale. To the extent these taxes are not collected (in the absence of an appropriate exemption), the seller is liable for such taxes plus interest. Land transfer tax is also payable by the buyer to the appropriate government authority.

Sale of shares

A Canadian-resident seller is taxable on 50 percent of any capital gains realized on a sale of shares. An exemption may be available to individuals for a portion of the gains realized on shares of qualifying private corporations. Prior to a share sale, shareholders owning more than 10 percent of the outstanding shares of a private company may undertake planning steps to crystallize the accumulated earnings of the target company through the payment of tax-free intercorporate dividends to a holding company. Such planning aims to increase the adjusted cost base of the seller's shares, thereby reducing the seller's capital gain arising on the sale.

Other concerns primarily relate to the negotiating process. The seller will want to ensure that all intangible and contingent assets are recognized and taken into account in arriving at the purchase price, including any losses or other attributes in the company that may be used by the buyer. Similarly, any tax indemnities and warranties (as discussed earlier) are a significant part of the negotiation process.

Taxable versus deferred sale

In the case of both an asset sale and a share sale, the seller will be concerned about whether to structure the transaction primarily as a taxable or tax-deferred disposal. Generally, in order for the sale to be tax-deferred, the seller must receive shares of the acquisition vehicle. In both an asset and a share sale, the seller can defer recognition of gains by receiving cash or debt ('boot') up to the tax basis of the assets or shares disposed and shares of the buyer for the balance of the purchase price. These transactions may be structured in a variety of ways.

Seller's preference: assets versus shares

Since a buyer prefers an asset deal, a seller may require a higher purchase price to sell assets rather than shares, due to the potentially higher tax cost on the sale of assets. The buyer may pay more for assets but should obtain some tax relief through higher depreciation and amortization.

Company law and accounting

Although not defined by statute, the term 'M&A' is used in Canada to describe combinations of business enterprises by means of an acquisition or other combination techniques, such as amalgamation, that are allowed under company law. A merger or acquisition involving shares of a Canadian company or its assets can be completed in a number of ways depending on the type of consideration to be paid (generally cash, shares, or other securities), tax and financing considerations, and company law and regulatory issues.

The applicable company law that governs a Canadian corporation depends on the jurisdiction of incorporation. A corporation can be incorporated under either the federal Canada Business Corporations Act (CBCA) or one of the provincial corporation statutes.

Canadian federal and provincial company laws provide for the statutory amalgamation of two or more predecessor companies into a single entity, provided each is governed by the same corporate statute. Thus, to amalgamate a corporation incorporated under provincial company law with another corporation incorporated under different provincial company law (or under federal company law), one corporation must be continued from its original jurisdiction into the other corporate jurisdiction (if allowed under its governing company law). Under Canadian company law, an amalgamated corporation essentially represents a continuation of each predecessor corporation, including all of their property

rights and liabilities (neither predecessor is considered as a 'survivor' of the other).

Company law generally does not require that each shareholder of a predecessor corporation becomes a shareholder of the amalgamated corporation. Thus, it is possible to structure a triangular amalgamation whereby shares of the parent company of one predecessor corporation are issued to shareholders of the other predecessor corporation on amalgamation.

Canadian accounting standards for business combinations generally align with International Financial Reporting Standards (IFRS) and require the acquisition of a business to be accounted for using business combination accounting, unless the acquisition represents a transaction between companies under common control. The net assets acquired are brought onto the consolidated balance sheet at their fair values, and goodwill arises to the extent that the consideration given exceeds the aggregate of these values. Goodwill is not amortized through the profit or loss account; it is subject to a mandatory annual impairment test. Business combination accounting also applies to purchases of assets, provided such assets constitute a business. Acquisitions of assets not constituting a business do not give rise to goodwill.

Group relief/consolidation

There is no tax-consolidation in Canada. Within a corporate group, it is advantageous to ensure that a situation does not arise where losses are incurred in one company and profits in another. It is possible to effect tax-deferred mergers of companies through liquidations of wholly owned subsidiaries or amalgamations of related companies whereby assets can be transferred at their tax basis and accumulated losses can be transferred to the parent on liquidation or to the amalgamated company. In addition, more complex loss-utilization structures can be implemented within a corporate group.

As discussed earlier, where a Canadian operating company is acquired by a Canadian acquisition company, it may be necessary to merge the acquiring and operating companies so that the interest on any acquisition debt is deductible against the profits of the operating company.

Transfer pricing

Canadian transfer pricing rules require a taxpayer transacting with a non-arm's length non-resident to use arm's length transfer prices and terms, and comply with certain contemporaneous documentation requirements. Failure to use arm's length transfer prices may result in a transfer pricing adjustment and penalties, including penalties for insufficient contemporaneous documentation.

After the acquisition, intercompany balances and arrangements between a foreign parent and its Canadian subsidiary that do not reflect arm's length terms may be subject to adjustment or re-characterization under Canada's transfer pricing rules.

Dual residency

All corporations governed by Canadian corporate statutes are deemed to be residents of Canada for tax purposes. There is little advantage in seeking to establish a Canadian company as a dual resident company.

Foreign investments of a local target company

Canada has comprehensive rules that impute income to a Canadian-resident shareholder in respect of foreign affiliates of the shareholder that earn investment income or income from a business other than an active business. As a result, a Canadian company is generally not the most efficient entity through which to hold international investments, unless the Canadian entities operate active businesses.

Comparison of asset and share purchases

Advantages of asset purchases

— A step-up in the tax basis of assets for capital gains purposes and depreciation purposes is obtained.

— A portion of the purchase price can be depreciated or amortized for tax purposes.

— A deduction is gained for inventory purchased at higher than book value.

— It can be contractually determined which liabilities the buyer will assume.

— Possible to acquire only part of a business.

— Flexibility in financing options.

— Profitable operations can be absorbed by loss companies in the buyer's group, provided certain planning is undertaken, gaining the ability to use the losses.

Disadvantages of asset purchases

— Possible need to renegotiate supply, employment and technology agreements.

— An asset sale may be less attractive to the seller, thereby increasing the purchase price.

— Transfer taxes on real property, GST/HST and PST on assets may be payable.

— Benefit of any losses incurred by the target company or any other tax attributes remains with seller.

Advantages of share purchases

— Usually more attractive to the seller, so the price may be lower.

— Buyer may benefit from tax losses and other tax attributes of the target company.

— Buyer may gain the benefit of existing supply and technology contracts.

— Buyer does not have to pay transfer taxes on shares acquired.

Disadvantages of share purchases

— Buyer acquires unrealized tax liability for depreciation recovery on the difference between original cost and tax book value of assets.

— Buyer is liable for all contingent and actual liabilities of the target company.

— No deduction for the excess of purchase price over tax value of assets.

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United States

Introduction

United States (US) law regarding mergers and acquisitions (M&A) is extensive and complex. Guidance for applying the provisions of the Internal Revenue Code of 1986, as amended (Code), is provided by the federal government, generally by the Internal Revenue Service (IRS) in revenue rulings, revenue procedures, private letter rulings, announcements, notices and Treasury Department regulations, and also by the courts.

In structuring a transaction, the types of entities involved in the transaction generally help determine the tax implications. Parties may structure a transaction in a non-taxable, partially taxable or fully taxable form. A non-taxable corporate reorganization or corporate organization generally allows the acquiring corporation to take a carryover basis in the assets of the target entity. In certain instances, a partially taxable transaction allows the acquiring corporation to take a partial step-up in the assets acquired, rather than a carryover basis. A taxable asset or share purchase provides a basis step-up in the assets or shares acquired. Certain elections made for share purchases allow the taxpayer to treat a share purchase as an asset purchase and take a basis step-up in the acquired corporation's assets.

Taxpayers generally are bound by the legal form they choose for the transaction. The particular legal structure selected by the taxpayer has substantive tax implications. Further, the IRS can challenge the tax characterization of the transaction on the basis that it does not clearly reflect the substance of the transaction.

Recent developments

This section summarizes US tax developments that occurred in 2016, 2017 and January 2018.

US tax reform

On 22 December 2017, the US President signed a new tax law (the 2017 Tax Law) that significantly affects US cross-border taxation. This new legislation is the most extensive rewrite of the US federal tax laws since the Tax Reform Act of 1986. The 2017 Tax Law, which affects both common US inbound and outbound structures, will have a significant impact on many foreign buyers of US companies. Most of the provisions of the 2017 Tax Law are effective 1 January 2018. Some provisions, however, have delayed or other effective dates.

The centerpiece of the new law is the permanent reduction in the corporate income tax rate from 35 percent to 21 percent. The rate reduction generally took effect on 1 January 2018. Special rules apply for fiscal year corporate filers.

The 2017 Tax Law is highly complex in that it layers new law over years of existing US federal tax law as well as eliminates and modifies various sections of existing tax law. Shortly after the 2017 Tax Law was signed into law, the US Treasury Department (Treasury) and the IRS commenced what is expected to be a lengthy and time-consuming process of drafting interpretative regulations and guidance that address the legislation's provisions. Generally, Treasury has 18 months to issue retroactive regulations addressing the 2017 Tax Law. Additionally, the US Congress may pass a 'technical corrections' bill that makes retroactive changes to the 2017 Tax Law.

The new law fundamentally changes the taxation of US multinational corporations and their foreign subsidiaries. US multinational corporations under the old law were subject to immediate and full US income taxation on all income from sources within and without the US. The earnings of foreign subsidiaries under the old law, however, were not subject to US income tax until the earnings were repatriated through dividend distributions. Prior to the act, an anti-deferral regime (subpart F) which dated back to 1962, applied to certain categories of foreign subsidiary earnings and taxed those earnings in the hands of the US corporate owners as if such amounts had been repatriated via dividend distribution.

By contrast, the earnings of foreign subsidiaries under the new law are either subject to immediate taxation under expanded anti-deferral provisions or are permanently exempt from US taxation. The new law generally retains the existing subpart F regime that applies to passive income and related-party sales and services income, and it creates a new, broad class of income ('global intangible low-taxed income' — GILTI) that is also deemed repatriated in the year earned and, thus, is also subject to immediate taxation. While GILTI is effectively taxed at a reduced rate, subpart F income is subject to tax at the full US rate.

To accomplish this shift to the new regime, the new law includes several key features, including:

— a 100 percent deduction for dividends received from 10 percent-owned foreign corporations

— a tax on GILTI

— a one-time transition tax or deemed repatriation tax on the accumulated earnings of certain foreign corporations.

Some of the stated goals in enacting the new tax law were simplification and a shift from a worldwide system of taxation to a territorial tax system (i.e. a tax system that taxes profits where they are earned). Whether the new law achieves these goals is debatable. The new tax law contains complex new provisions that will require significant reasoned analysis and judgment, as well as additional administrative guidance to properly implement. While it might be nominally accurate to state that the new tax system moves towards a territorial system — because certain profits earned by foreign subsidiaries are not subject to immediate taxation and will not be taxed when repatriated — the non-taxable profits are (in most situations) a small portion of the profit pool. Moreover, by expanding the anti-deferral regime to include GILTI (albeit at a reduced effective rate), the new tax law expands the base of cross-border income that is subject to immediate US income taxation.

Other key provisions of the new law are a reduced tax rate for a new class of income earned directly by US corporations ('foreign-derived intangibles income') and a new tax (the 'base erosion and anti-abuse tax' — BEAT) on deductible payments made by US corporations to related foreign persons.

Various provisions of the 2017 Tax law are discussed in further detail throughout this report. As a general matter, it is important to keep in mind that many of the 2017 Tax Law's provisions will affect foreign buyers of US targets and, more generally, foreign multinationals that have significant US operations. In practice, some of the provisions will operate to increase US taxable income when applicable. Due to the significant changes, consideration of US tax reform developments is especially important when completing tax due diligence reviews, defining tax indemnities, and undertaking acquisition integration planning. From a tax due diligence perspective, areas of key focus from a US tax reform perspective include, for example, consideration of:

— whether the US target has properly calculated its mandatory repatriation tax (if applicable)

— whether the US target has any structures or transaction flows in place that would give rise to US tax exposures, for example, under the new BEAT regime and/or the new hybrid mismatch rule

— whether the US target is highly leveraged

— whether US target has any intellectual property (IP) planning structures in place.

For those foreign companies with significant US operations that do not plan accordingly (e.g. through supply chain restructuring), the collective application of certain provisions of the 2017 Tax Law could result in an unfavorable impact on a foreign company's global effective tax rate despite the US corporate tax rate reduction. To determine whether any particular company is a winner or loser under US tax reform, it is essential to model the impact of the 2017 Tax Law's relevant provisions (e.g. the provisions that limit interest deductions and seek to prevent US tax base erosion) using company specific facts.

Asset purchase or share purchase

The decision to acquire assets or stock is relevant in evaluating the potential tax exposures that a buyer may inherit from a target corporation. A buyer of assets generally does not inherit the US tax exposures of the target, except for certain successor liability for state and local tax purposes and certain state franchise taxes. Also, an acquisition of assets constituting a trade or business may result in amortizable goodwill for US tax purposes. However, there may be adverse tax consequences for the seller in an asset acquisition (e.g. depreciation recapture and double taxation resulting from the sale followed by distribution of the proceeds to foreign shareholders).

By contrast, in a stock acquisition, the target's historical liabilities, including liabilities for unpaid US taxes, generally remain with the target (effectively decreasing the value of the buyer's investment in the target's shares). In negotiated acquisitions, it is usual and recommended that the seller allow the buyer to perform a due diligence review, which, at a minimum, should include review of:

— the adequacy of tax provisions/reserves in the accounts, identifying open years and pending income tax examinations

— the major differences in the pre-acquisition book and tax balance sheets

— the existence of special tax attributes (e.g. net operating loss — NOL), how those attributes were generated, and whether there are any restrictions on their use

— issues relating to acquisition and post-acquisition tax planning.

Under US tax principles, the acquisition of assets or stock of a target may be structured such that gain or loss is not recognized in the exchange (tax-free reorganization). Such transactions allow the corporate structures to be rearranged from simple recapitalizations and contributions to complex mergers, acquisitions and consolidations.

Typically, a tax-free reorganization requires a substantial portion of the overall acquisition consideration to be in the form of stock of the acquiring corporation or a corporation that controls the acquiring corporation. However, for acquisitive asset

reorganizations between corporations under common control, cash and/or other non-stock consideration may be used.

There may be restrictions on the disposal of stock received in a tax-free reorganization. The buyer generally inherits the tax basis and holding period of the target's assets, as well as the target's tax attributes. However, where certain built-in loss assets are imported into the US, the tax basis of such assets may be reduced to their fair market value.

In taxable transactions, the buyer generally receives a cost basis in the assets or stock, which may result in higher depreciation deductions (or immediate expensing for certain tangible assets under the 2017 Tax Law) for taxable asset acquisitions (assuming the acquired item has a built-in gain).

In certain types of taxable stock acquisitions, the buyer may elect to treat the stock purchase as a purchase of the assets (section 338 election discussed later — see this report's information on purchase of shares). Generally, US states and local municipalities respect the federal tax law's characterization of a transaction as a taxable or tax-free exchange.

Careful consideration must be given to cross-border acquisitions of stock or assets of a US target. Certain acquisitions may result in adverse tax consequences under the corporate inversion rules. Depending on the amount of shares of the foreign acquiring corporation issued to the US target shareholders, the foreign acquiring corporation may be treated as a US corporation for all US federal income tax purposes. In some cases, the US target may lose the ability to reduce any gain related to an inversion transaction by the US target's tax attributes (e.g. NOLs and foreign tax credits — FTC).

Purchase of assets

In a taxable asset acquisition, the purchased assets have a new cost basis for the buyer (if not immediately expensed under the 2017 Tax Law). The seller recognizes gain (either capital or ordinary) on the amount that the purchase price exceeds its tax basis in the assets. An asset purchase generally provides the buyer with the opportunity to select the desired assets, leaving unwanted assets behind. While a section 338 election (described later) is treated as an asset purchase, it does not necessarily allow for the selective purchase of the target's assets or avoidance of its liabilities.

An asset purchase may be recommended where a target has potential liabilities and/or such transaction structure helps facilitate the establishment of a tax-efficient structure post-acquisition. For example, under certain conditions, a tax basis step-up resulting from a transaction treated as an asset purchase can help mitigate exposure to the new so-called GILTI tax imposed by the 2017 Tax Law on a go-forward basis. For a discussion of the new GILTI provision, see 'Integration planning for US target-owned intellectual property' later in this report.

Purchase price

In a taxable acquisition of assets that constitute a trade or business, the buyer and seller are required to allocate the purchase price among the purchased assets using a residual approach among seven asset classes described in the regulations. The buyer and seller are bound by any agreed allocation of purchase price among the assets.

Contemporaneous third-party appraisals relating to asset values can be beneficial.

Depreciation and amortization

The purchase price allocated to certain tangible assets, such as inventory, property, plant and equipment, provides future tax deductions in the form of cost of sales or depreciation. As stated earlier, in an asset acquisition, the buyer receives a cost basis in the assets acquired for tax purposes. Frequently, this results in a step-up in the depreciable basis of the assets but could result in a stepdown in basis where the asset's fair market value is less than the seller's tax basis.

Most tangible assets are depreciated over tax lives ranging from 3 to 10 years under accelerated tax depreciation methods, thus resulting in enhanced tax deductions.

Buildings are depreciable using a straight-line depreciation method generally over 39 years (27.5 years for residential buildings). Other assets, including depreciable land improvements and many non-building structures, may be assigned a recovery period of 15 to 25 years, with a less accelerated depreciation method.

In certain instances, section 179 allows taxpayers to elect to treat as a current expense the acquired cost of tangible property and computer software used in the active conduct of a trade or business. Under the 2017 Tax Law, the deductible section 179 expense limitation is generally 1 million US dollars (US$). This limitation, which is adjusted annually for inflation, is reduced dollar-for-dollar to the extent the total cost of section 179 property placed in service during the year exceeds US$2.5 million.

Separately from section 179, so-called 'qualified property' used in a taxpayer's trade or business or for the production of income may be subject to an additional depreciation deduction ('bonus depreciation') in the first year the property is placed into service. The 2017 Tax Law expands bonus depreciation to include a 100 percent deduction for the cost of qualified property (generally tangible depreciable property with a depreciation life of less than 20 years) acquired from unrelated persons and placed in service after 27 September 2017, and before 1 January 2023. The 2017 Tax Law includes a 20 percent increment phase-down of the 'bonus' depreciation percentage for property acquired after 2022. Specifically, the 2017 Tax Law allows businesses to expense 80 percent, 60 percent, 40 percent and 20 percent of the cost of property placed in service in 2023, 2024, 2025 and 2026, respectively. Under the 2017 Tax Law, bonus depreciation is completely phased out in 2027.

Unlike under prior law, the 2017 Tax Law does not limit bonus appreciation to 'original use property' that begins with the

taxpayer. Specifically, under the 2017 Tax Law, both original-use and used tangible property that is 'new' to the taxpayer qualifies for bonus depreciation if certain conditions are met. This change governing immediate expensing provides an incentive for foreign buyers of asset-intensive US companies (e.g. manufacturing businesses) to structure business acquisitions as asset purchases or deemed asset purchases (e.g. section 338 elections) instead of stock purchases in those cases where the US target has significant assets that would qualify for 100 percent expensing. When applicable, the 100 percent bonus depreciation rule provides buyers of qualifying US assets with the opportunity to essentially deduct a portion of the purchase price allocable to qualifying tangible property.

Due to the enhanced bonus depreciation provision, it is also anticipated that a seller of a US target company may also be more willing to sell assets than before due to the US corporate tax rate reduction and 100 percent expensing for qualifying purchases of depreciable tangible property. Under the 2017 Tax Law, a C corporation that sells an asset and reinvests the proceeds into qualifying depreciable tangible property receives a cash tax benefit due to acceleration of deductions. Specifically, under the 2017 Tax Law, the net effect is a 21 percent tax on the gain realized on the sale, and a 21 percent deduction for the reinvested proceeds if the property qualifies for 100 percent expensing.

Bonus depreciation automatically applies to qualified property, unless a taxpayer elects to apply the general rules to the full basis. Specifically, under a separate election, a taxpayer can forego any bonus depreciation and accelerate the use of certain credit carryovers from earlier years. Where this election is made, the taxpayer is required to use straight-line depreciation for all of its qualified property, with no bonus deduction.

Where both the section 179 expense and bonus depreciation are claimed for the same asset, the asset basis must first be reduced by the section 179 expense before applying the bonus depreciation rules.

Land is not depreciable for tax purposes. Also, accelerated depreciation, the section 179 deduction and bonus depreciation are unavailable for most assets considered predominantly used outside the US.

Generally, the capitalized cost of most acquired intangibles, including goodwill, going concern value and non-compete covenants, are amortizable over 15 years. A narrow exception — the so-called 'anti-churning rules' — exists for certain intangibles that were not previously amortizable, where they were held, used or acquired by the buyer (or related person) before the effective date.

Under the residual method of purchase price allocation, any premium paid that exceeds the aggregate fair market value of the acquired asset is characterized as an additional amount of goodwill and is eligible for the 15-year amortization.

Costs incurred in acquiring assets — tangible or intangible — are typically added to the purchase price and considered part of their basis, and they are depreciated or amortized along with the acquired asset. A taxpayer that produces or otherwise self-constructs tangible property may also need to allocate a portion of its indirect costs of production to basis; this can include interest expense incurred during the production period.

Tax attributes

The seller's NOLs, capital losses, tax credits and other tax attributes are not transferred to the buyer in a taxable asset acquisition. In certain circumstances where the target has substantial tax attributes, it may be beneficial to structure the transaction as a sale of its assets so that any gain recognized may be offset by the target's tax attributes. Such a structure may also reduce the potential tax for the target's stockholder(s) on a sale of its shares where accompanied by a section 338 or 336(e) election to treat a stock purchase as a purchase of its assets for tax purposes (assuming the transaction meets the requirements for such elections; see this report's information on purchase of shares).

Value added tax

The US does not have a value added tax (VAT). Certain state and local jurisdictions impose sales and use taxes, gross receipts taxes and/or other transfer taxes.

Transfer taxes

The US does not impose stamp duty taxes at the federal level on transfers of tangible or intangible assets including stock, partnership interests and membership interests in limited liability companies (LLCs). Certain state and local jurisdictions impose sales and use tax on the sale of certain tangible assets; however, the buyer may be able to benefit from exemptions from sales and use tax where all or a substantial portion of the target's assets are acquired through bulk sale and/or occasional sale provisions.

Typically, state or local transfer taxes are not applicable to the transfer of intangible assets, such as stock, partnership interests and LLC membership interests. However, the majority of states and certain local jurisdictions impose a tax on the actual transfer of real estate. In certain cases, some of these jurisdictions impose a tax on the transfer of a beneficial or controlling interest in real estate.

Purchase of shares

As stated earlier, in a stock acquisition, the target's historical tax liabilities remain with target, which affects the value of the buyer's investment in target stock. In addition, the target's tax basis in its assets generally remains unchanged. The target continues to depreciate and amortize its assets over their remaining lives using the methods it previously used. Although the target retains its tax attributes in a stock acquisition, its use of its NOLs and other favorable tax attributes may be limited where it experiences what is referred to as an 'ownership change' (see 'Tax losses and other attributes').

Additionally, costs incurred by the buyer and the target in connection with the stock acquisition are generally not deductible (but are capitalized into the basis of the shares acquired).

In a taxable purchase of the target stock, an election can be made to treat the purchase of stock as a purchase of the target's assets, provided certain requirements are satisfied. The buyer, if eligible, can make either a unilateral election under section 338(g) (338(g) election) or, if available, a joint election (with the common parent of the consolidated group of which the target is a member or with shareholders of a target S corporation) under section 338(h)(10) (338(h)(10) election).

Alternatively, the seller and target can make a joint election, provided they satisfy the rules under section 336(e) (336(e) election). Similar to a section 338 election, the section 336(e) election treats a stock sale as a deemed asset sale for tax purposes, thereby providing the buyer a basis in the target's assets equal to fair market value. Unlike the rules under section 338, however, the buyer does not have to be a corporation.

In certain circumstances involving a taxable stock sale between related parties, special rules (section 304) may re-characterize the sale as a redemption transaction in which a portion of the sale proceeds may be treated as a dividend to the seller. Whether the tax consequences of this recharacterization are adverse or beneficial depends on the facts. For example, if tax treaty benefits are not available, the dividend treatment may result in the imposition of US withholding tax (WHT) at a 30 percent rate on a portion of the sale proceeds paid by a US buyer to a foreign seller. On the other hand, the dividend treatment may be desirable on sales of foreign target stock by a US seller to a foreign buyer, both of which are controlled by a US parent corporation. In this case, the resulting deemed dividend from the foreign buyer and/or foreign target will generally be exempt from US federal income tax under the new participation exemption implemented by the 2017 Tax Law as long as certain conditions are met.

Tax indemnities and warranties

In a stock acquisition, the target's historical tax liabilities remain with target. As such, it is important that the buyer procures representations and warranties from the seller (or its stockholders) in the stock purchase agreements to ensure that it is not exposed to any post-transaction liabilities (e.g. the new mandatory repatriation tax) arising from the target's pre-transaction activities. Where significant sums are at issue, the buyer generally performs a due diligence review of the target's tax affairs. Generally, the buyer seeks tax indemnifications for a period through at least the expiration of the statute of limitations, including extensions. The indemnity clauses sometimes include a cap on the indemnifying party's liability or specify a dollar amount that must be reached before indemnification occurs. Please note that KPMG LLP in the US cannot and does not provide legal advice. The purpose of this paragraph is to provide general information on tax indemnities and warranties that needs to be addressed and tailored by the client's legal counsel to the client's facts and circumstances.

Tax losses and other attributes

The 2017 Tax Law modifies the rules that govern the utilization of net operating losses (NOLs). Effective for losses arising in tax years beginning after 31 December 2017, NOL deductions for a given year are generally limited to 80 percent of a corporation's taxable income. Under the 2017 Tax Law, NOLs are generally no longer eligible for carryback. Unlike under prior law, however, the 2017 Tax Law provides for the indefinite carryforward of NOLs arising in tax years ending after 31 December 2017. Prior law generally provided a 2-year carryback and 20-year carryforward for NOLs.

As a result of the new 80 percent limitation and other changes, corporations now need to track NOLs arising in tax years beginning on or before 31 December 2017, separately from NOLs arising after 31 December 2017. Utilization of NOLs arising in years beginning before 31 December 2017, are not subject to the new 80 percent limitation and continue to be subject to the 20-year expiration rule imposed by prior law.

Where capital losses are concerned, the 2017 Tax Law does not appear to limit the 3-year capital loss carryback allowed for corporations or impose a limitation on the utilization of capital loss carryovers.

Section 382 imposes one of the most significant limitations on the utilization of target's NOLs (as well as capital losses and credits). Section 382 generally applies where a target that is a loss corporation undergoes an 'ownership change'. Generally, an ownership change occurs when more than 50 percent of the beneficial stock ownership of a loss corporation has changed hands over a prescribed period (generally 3 years).

The annual limitation on the amount of post-change taxable income that may be offset with pre-change NOLs is generally equal to the adjusted equity value of the loss corporation multiplied by a long-term tax-exempt rate established by the IRS. The adjusted equity value used in calculating the annual limitation is generally the equity value of the loss corporation immediately before the ownership change, subject to certain potential downward adjustments. Common such adjustments include acquisition debt pushed down to the loss corporation and certain capital contributions to the loss corporation within the 2-year period prior to the ownership change.

Similar to section 382, it is important to note that section 383 also seeks to restrict monetization of a loss corporation's tax attributes by another profitable corporation.

In addition to changing the NOL rules, the 2017 Tax Law also repealed the US corporate alternative minimum tax (AMT) regime for tax years beginning after 31 December 2017. Excess AMT credits that have not yet been claimed are generally refundable up to fifty percent through 2021; after 2021, any remaining AMT credit is fully refundable. As a

practical matter, utilizing excess AMT credits and generating cash refunds as a result of such credits may be difficult for some taxpayers that face a 383 limitation.

Crystallization of tax charges

We will describe below consequences of a member of a consolidated group leaving such group.

A corporation's departure from a consolidated group is subject to the complex regulations that apply to US consolidated groups. Very generally, one consequence of a corporation's departure from a consolidated group is the acceleration of any deferred items from transactions between the departing corporation and other members of the consolidated group. For example, gain on the sale of an item of property by one member of a consolidated group (S) to another consolidated group member (B) will generally be deferred under the consolidated return regulations until that property is transferred out of the consolidated group. If, however, either S or B leaves the consolidated group, S's deferred gain will be accelerated and includible in taxable income (if S is the departing member, the deferred gain will be taken into account by S immediately before S leaves the consolidated group). There is an exception to this acceleration of deferred items for certain cases in which the entire consolidated group having the deferred items is acquired by another consolidated group.

Within a consolidated group, it is possible for a company (S) to have a negative tax basis in the shares of another company (B). This is referred to as an excess loss account and can arise as a result of debt leveraged distributions (e.g. B borrows in order to fund a dividend distribution) or debt leveraged generation of losses (e.g. B borrows and spends the proceeds on operating its business). Like the deferred intercompany items previously discussed, immediately before either B or S leaves the consolidated group, any excess loss account must be recognized as taxable income. There is an exception to this excess loss account recognition for certain cases in which the entire consolidated group having the excess loss account(s) is acquired by another consolidated group.

The departure of a corporation from a consolidated group raises numerous issues besides the acceleration of deferred items described above. For example, when a corporation ceases to be a member of a consolidated group during the tax year, consideration must be given to the allocation of income, gain, loss, deduction, credit, and potentially other attributes between the departing corporation and the consolidated group. The consolidated return regulations also contain complex rules that may reduce or eliminate loss realized (and/or certain tax attributes) on the departure of a consolidated group member. In addition, note that the departing corporation is potentially liable for the consolidated group's entire tax liability for each year in which the departing corporation was a member of the consolidated group (even for a day), including the year in which the subsidiary leaves the consolidated group.

Pre-sale dividend

In certain circumstances, the seller may prefer to realize part of the value of its investment in the target through a pre-sale dividend. This may be attractive where the dividend is subject to tax at a rate that is lower than the tax rate on capital gains.

Generally, for corporations, dividends and capital gains are subject to tax at the same federal corporate tax rate of 21 percent. However, depending on the ownership interest in the subsidiary, a seller may be entitled to various amounts of dividend-received deduction (DRD) on dividends received from a US subsidiary if certain conditions are met. However, certain dividends may also result in reducing the tax basis of the target's stock by the amount of the DRD.

An individual is generally taxed on capital gains and dividends from domestic corporations and certain foreign corporations based on their overall income tax bracket. See below for long-term capital gains rates for tax years beginning after 31 December 2017. Qualified dividends are generally taxed at the general long-term capital gains rate.

Individuals are not entitled to DRDs on dividends. Thus, the tax effect of a pre-sale dividend may depend on the recipient's circumstances. Each case must be examined on its facts. In certain circumstances, proceeds of pre-sale redemptions of target stock may also be treated as a dividend by the recipient stockholder (see 'Equity').

Tax bracket	Long-term capital gains and dividend tax rate
10 and 12 percent	0 percent
22, 24, 32 and 35 percent	15 percent
37 percent	20 percent

Source: Internal Revenue Code

Transfer taxes

The US does not impose a federal stamp duty tax. Certain states may impose a tax on the transfer of a controlling interest in the ownership of a company, which generally applies only to certain assets, including real property and certain leases of real property.

Tax clearances

Generally, a clearance from the IRS is not required prior to engaging in an acquisition of stock or assets. A taxpayer can request a private letter ruling, which is a written determination issued to a taxpayer by the IRS national office in response to a written inquiry about the tax consequences of the contemplated transactions.

Although it provides a measure of certainty on the tax consequences, the ruling process can be protracted and time-consuming and may require substantial expenditures on

professional fees. Thus, the benefits of a ruling request should be carefully considered beforehand.

Private letter rulings are taxpayer-specific and can only be relied on by the taxpayers to whom they are issued. Pursuant to section 6110(k)(3), such items cannot be used or cited as precedent. Nonetheless, such rulings can provide useful information about how the IRS may view certain issues.

Choice of acquisition vehicle

A particular type of entity may be better suited for a transaction because of its potential tax treatment. Previously, companies were subject to a generally cumbersome determination process to establish entity classification. However, the IRS and Treasury issued regulations that allow certain eligible entities to elect to be treated as a corporation or a partnership (where the entity has more than one owner) or as a corporation or disregarded entity (where the entity has only one owner). Rules governing the default classification of domestic entities are also provided under these regulations.

A similar approach is available for classifying eligible foreign business organizations, provided such entities are not included in a prescribed list of entities that are per se corporations (i.e. always treated as corporations).

Taxpayers are advised to consider their choice of entity carefully, particularly when changing the classification of an existing entity. For example, where an association that is taxable as a corporation elects to be classified as a partnership, the election is treated as a complete liquidation of the existing corporation and the formation of a new partnership. The election could thus constitute a material realization event that might entail substantial adverse immediate or future US tax consequences.

Local holding company

A US incorporated corporation is often used as a holding company and/or acquisition vehicle for the acquisition of a US target or a group of assets. Under the 2017 Tax Law, a corporation is now generally subject to an entity-level federal corporate income tax rate of 21 percent (lower taxable income amounts may be subject to lower rate brackets), plus any applicable state and/or local taxes.

Despite the entity-level tax, a corporation may be a useful vehicle to achieve US tax consolidation to offset income with losses between the target group members and the buyer, subject to certain limitations (see 'Group relief/consolidation'). Moreover, a corporation may be used to push down acquisition debt so that interest may offset the income from the underlying companies or assets. However, as noted earlier, a debt pushdown may limit the use of a target's pre-acquisition losses under the section 382 regime (see 'Tax losses and other attributes').

Where a non-US person is a shareholder in a corporation, consideration should also be given to the Foreign Investment Real Property Tax Act (FIRPTA) (see next section).

Foreign parent company

Where a foreign corporation is directly engaged in business in the US through a US branch (or owns an interest in a fiscally transparent entity that conducts business in the US), it may be subject to net basis US taxation at the 21 percent corporate rate on income that is effectively connected to the US business (but only in the case of an entity entitled to benefits under a tax treaty, if that income is attributable to a US permanent establishment). The US also imposes additional tax at a 30 percent rate on branch profits deemed remitted overseas (subject to tax treaty rate reductions or exemptions). In addition, the foreign corporation will generally be subject to tax return filing obligations in the US.

Alternatively, a foreign corporation may be used as a vehicle to purchase US target stock, since foreign owners are generally not taxed on the corporate earnings of a US subsidiary corporation. However, dividends or interest from a US target remitted to a foreign corporation may be subject to US WHT at a 30 percent rate (which may be reduced under a tax treaty). Thus, careful consideration may be required where, for example, distributions from a US target are required to service debt of the foreign corporation (e.g. holding the US target through an intermediate holding company, as discussed later in this report).

Generally, the foreign corporation's sale of US target stock should not be subject to US taxation unless the US target was a US real property holding corporation (USRPHC) at any time during a specified measuring period. This would be the case where the fair market value of the target's US real property interests was at least 50 percent of the fair market value of its global real property interests plus certain other property used in its business during that specified measuring period. The specified measuring period generally is the shorter of the 5-year period preceding the sale or other disposition and the foreign corporation's holding period for the stock.

A foreign seller of USRPHC stock may be subject to US income tax on the gain at standard corporate tax rates (generally 21 percent) and a 15 percent US WHT on the amount realized, including assumption of debt (the WHT is creditable against the tax on the gain). In addition, a sale of USRPHC stock gives rise to US tax return filing obligations.

Non-resident intermediate holding company

An acquisition of the stock of a US target may be structured through a holding company resident in a jurisdiction that has an income tax treaty with the US (an intermediate company) potentially to benefit from favorable US and foreign tax treaty WHT rates.

However, the benefits of the structure may be limited under anti-treaty shopping provisions found in most US treaties or under the US federal tax rules (e.g. Code, regulations).

Joint venture

Multiple buyers may use a joint venture vehicle to purchase a US target or US assets. A joint venture may be organized either as a corporation or a fiscally transparent entity (a flow-through venture), such as a partnership or LLC. A joint venture corporation may face issues similar to those described earlier (see 'Local holding company').

A flow-through venture generally is not subject to US income tax at the entity level (except in some states). Instead, its owners are taxed directly on their proportionate share of the flow-through venture's earnings, whether or not distributed. Where the flow-through venture conducts business in the US, the foreign owners may be subject to net basis US taxation on their share of its earnings, as well as US WHT and US tax return filing obligations.

Choice of acquisition funding

Generally, a buyer (or an acquisition vehicle) finances the acquisition of a US target with its own cash, issuance of debt or equity or a combination of both. The capital structure is critical due to the potential deductibility of debt interest. Certain US tax reform developments raise tax exposure concerns for a number of common US inbound acquisition financing structures (e.g. US inbound acquisition financing structures involving Luxembourg entities). The new Section 385 Regulations (see 'Deductibility of interest') also raise various considerations for US inbound acquisition financing. Buyers of US target companies should carefully consider both US tax reform developments and recommendations from the Organisation for Economic Co-operation and Development (OECD) to counter base erosion and profit shifting (BEPS), as well as the new Section 385 Regulations when deciding on what acquisition funding structure to use.

Debt

An issuer of debt may be able to deduct interest against its taxable income (see 'Deductibility of interest'), whereas dividends on stock are non-deductible. Additionally, debt repayment may allow for tax-free repatriation of cash, whereas certain stock redemptions may be treated as dividends and taxed as ordinary income to the stockholder. Similar to dividends, interest may be subject to US WHT.

The debt placement and its collateral security should be carefully considered to help ensure that the debt resides in entities that are likely to be able to offset interest deductions against future profits. The debt should be adequately collateralized to help ensure that the debt will be respected as a genuine indebtedness. Moreover, the US debtor may recognize current income where the debt is secured by a pledge of stock or assets of controlled foreign companies (CFC). See 'Foreign investments of a US target company'.

Deductibility of interest

Interest paid or accrued during a taxable year on a genuine indebtedness of the taxpayer generally is allowed as a tax deduction during that taxable year, subject to several exceptions, some of which are described below.

For interest to be deductible, the instrument (e.g. notes) must be treated for US tax purposes as debt and not as equity. The characterization of an instrument is largely based on facts, judicial principles and IRS guidance. Although a brief list of factors cannot be considered complete, some of the major considerations in the debt-equity characterization include:

— the intention of the parties to create a debtor-creditor relationship

— the debtor's unconditional obligation to repay the outstanding amounts on a fixed maturity date

— the creditor's rights to enforce payments

— the thinness of the debtor's capital structure in relation to its total debt.

Shareholder loans must reflect arm's length terms to avoid being treated as equity. Where a debtor has limited capability to service bank debt, its guarantor may be treated as the primary borrower. As a result, the interest accrued by the debtor may be re-characterized as a non-deductible dividend to the guarantor. This may entail additional US WHT consequences where the guarantor is a foreign person.

Interest deductions may be limited for certain types of acquisition indebtedness where interest paid or incurred by a corporation during the taxable year exceeds US$5 million, subject to certain adjustments. However, this provision generally should not apply if the debt is not subordinated or convertible.

A US debtor's ability to deduct interest on debt extended or guaranteed by a related foreign person may be further limited under the earnings-stripping rules. For taxable years beginning after 31 December 2017, the 2017 Tax Law substantially amends the earnings-stripping provision provided by section 163(j) of the Code (the section 163(j) earnings-stripping provision) to generally disallow US tax deductions for 'all' net business interest expense of any taxpayer in excess of 30 percent of a business's 'adjusted taxable income' (ATI). If certain conditions are met, the section 163(j) earnings-stripping provision can result in disallowance of interest expense deductions regardless of a taxpayer's business form and whether the interest is owed to a related or third party.

For purposes of the section 163(j) earnings-stripping provision, business interest of a corporation includes any interest paid or accrued on indebtedness properly allocable to a trade or business. Under the 2017 Tax Law, disallowed interest expense can be carried forward indefinitely to subsequent taxable years. During the tax due diligence phase, a buyer of a company that has a disallowed interest expense carryforward

should consider the extent to which section 382 imposes limitations on the utilization of this tax attribute.

Historically, the section 163(j) earnings-stripping provision only applied to limit interest deductions on foreign 'related-party' borrowings and/or borrowings guaranteed by a related party to 50 percent of earnings before interest, taxes, depreciation and amortization (EBITDA). The 2017 Tax Law provides no grandfathering rule for debt existing before 2018.

Depending on a US target's facts, the new interest expense limitations under the section 163(j) earnings-stripping provision (and certain other new provisions — e.g. the new hybrid mismatch rule) could result in increased taxable income for US target. During the tax due diligence phase, it is important to evaluate a US target company's US and global debt levels and to test US target's section 163(j) deductibility threshold. This analysis will help the foreign buyer determine potential US tax impact of existing debt levels, new debt and refinancings. This analysis will also help foreign buyer evaluate the viability of alternative tax planning options for financing the acquisition of a US target company. Depending on the facts and circumstances, some planning opportunities to mitigate the impact of interest deduction limitations under revised section 163(j) may exist.

For testing purposes, the section 163(j) earnings-stripping provision is performed at the level of the tax filing entity. The conference report for the 2017 Tax Law states that the section 163(j) limitation should be applied 'after' other interest disallowance, deferral, capitalization or other limitation provisions. Similar to NOLs, utilization of a US target's disallowed interest expense carryforwards is subject to limitations following a change of control.

As a general matter, foreign companies with highly leveraged US operations should consider whether an excess interest situation currently exists or might exist in the foreseeable future. During the tax due diligence phase, a foreign buyer should consider undertaking this same inquiry for potential US target companies as well. If an excess interest situation does exist, it may make sense for the foreign company to explore ways to shift debt burden from the United States to an overseas affiliate that has sufficient debt capacity under local country rules. Also, other planning opportunities for further consideration may also exist. For example, by agreeing to a higher cost of goods sold (COGS) from suppliers in exchange for 90 days of trade credits (as opposed to borrowing in order to finance COGS on a real-time basis), it might be possible to convert interest expense that would otherwise be disallowed as a deduction under the section 163(j) earnings-stripping provision into a deductible business expense. (Before undertaking any COGS planning, it is important to consider whether such planning could give rise to unanticipated US trade and customs costs).

As of January 2018, it is unclear whether a corporation can treat interest expense that was deferred and carried forward under the legacy section 163(j) earnings-stripping provision as business interest paid or accrued in a tax year beginning after 2017. Foreign buyers of US target companies should keep this uncertainty in mind when evaluating during the tax due diligence phase whether it will be able to utilize in the future a US target's disallowed interest expense carryforwards for tax years 2017 and before (if any).

In addition to the limitations discussed above, other limitations apply to interest on debt owed to foreign related parties and to certain types of discounted securities. For example, in October 2016, Treasury released final and temporary regulations that seek to prevent companies from eroding the US tax base via deductible intercompany loans (the Final 385 Regulations). As a general matter, the Final 385 Regulations restrict the tax benefit of using intercompany debt in M&A transactions that involve foreign entity acquisitions of US target companies. Due to the nature of how the Final 385 Regulations operate, these regulations can impact transaction structuring, tax due diligence and general tax planning.

The cornerstones of the Final 385 Regulations involve recast and documentation rules (hereafter, the Section 385 Recast Rule and the Section 385 Documentation Rules, respectively). Unless an exception applies, the general rule of the Section 385 Recast Rule treats a debt instrument issued by a US corporation to a related party after 4 April 2016, as equity if the debt instrument was issued:

— as a distribution of property

— to purchase related-party stock from a related-party seller; or

— in exchange for property from a related party in an asset reorganization.

The Section 385 Recast Rule also provides a so-called funding rule that treats a debt instrument issued by a US corporation to a related party after 4 April 2016, as stock if it is issued for property (e.g. cash) and with a principal purpose of funding one of the transactions listed above. To prevent recast of a debt instrument as equity under this funding rule, it is critical that the borrower refrain from the following activities during the 36-month period before and after the loan issuance:

— making distributions in an aggregate amount that exceeds earnings and profits (E&P) earned in taxable years ending after 4 April 2016

— purchasing stock of a related party; and

— engaging in other transactions prohibited by the Section 385 Regulations with a related party.

As for the 385 Documentation Rules (which are not yet effective as of January 2018), these rules generally require a US company to satisfy specific documentation and financial due diligence standards for:

— instruments issued in the legal form of a debt instrument; and

— certain intercompany payables and receivables documented as debt in a ledger, accounting system, or similar arrangement.

For example, written documentation must establish:

— an unconditional obligation to pay a sum certain on demand or at one or more fixed dates

— that the holder has typical creditor rights

— that there is a reasonable expectation of the borrower's ability to service and repay the related-party debt as of the issuance date

— proof of principal and interest payments

— enforcement rules for creditor rights.

Failure to comply with the 385 Documentation Rules (once, and if, they become effective) may result in intercompany debt being recharacterized as stock for US federal income tax purposes. As previously noted, unlike the 385 Recast Rules, the 385 Documentation Rules are not yet effective as of January 2018. As of January 2018, the 385 Documentation Rules are scheduled to apply to interests issued or deemed issued on or after 1 January 2019. As of January 2018, it is not clear whether Treasury will withdraw all or parts of the controversial Section 385 Regulations. Due to the 2017 Tax Law's changes to the earnings-stripping rules and certain other changes, there appears to be significantly less need for the Section 385 Regulations.

Though the 385 Documentation and Recast Rules are primarily relevant to foreign-parented multinationals that own or acquire US corporations (or to buyers of such foreign-parented multinational groups), these rules can also apply to:

— debt between affiliated US corporations that do not file a consolidated return

— members of a US-parented group that incur indebtedness, including pursuant to cash pooling arrangements, with foreign group members; and

— a US parent that incurs indebtedness to a foreign subsidiary (section 956 debt).

For debt issued before 4 April 2016, the Section 385 Regulations do not apply, provided that the debt was not modified after 4 April 2016.

As a general matter, foreign parent entities (whether top-tier parents or intermediate parents) that have US subsidiaries should review their intercompany debt for section 385 compliance. To the extent that debt will be affected by the Section 385 Regulations, the effective tax rate of the international group could be effected. For taxpayers to whom the 385 Recast Rules apply — principally foreign multinationals — it is important that appropriate processes (i.e. internal tracking systems) be in place in order to track covered debt issuances and de-funding transactions, and to prevent unintended recasts. For potential acquisition targets, enhanced tax due diligence may be necessary to determine:

— whether the 385 Recast Rules apply

— if the 385 Recast Rule does apply, whether any debt is properly recast as equity under this rule

— the tax impact of any 385 recasts of debt as equity.

As a general matter, the following implications (among others) can arise if debt is recast as equity under the 385 Recast Rule:

— disallowance of interest deductions

— US withholding tax consequences

— inability to treat cash repatriations from a US subsidiary to its foreign parent as a tax-free return of principal.

As for the 385 Documentation Rules, compliance with these rules will, once (and if) they go into effect, become a standard part of M&A tax due diligence and transaction planning for US target companies.

Withholding tax on debt and methods to reduce or eliminate it

The US imposes a 30 percent US WHT on interest payments to non-US lenders unless a statutory exception or favorable US treaty rate applies. Further, structures that interpose corporate lenders in more favorable tax treaty jurisdictions may not benefit from a reduced WHT because of the conduit financing regulations of section 1.881-3 and anti-treaty shopping provisions in most US treaties. (See 'Non-resident intermediate holding company').

No US WHT is imposed on portfolio interest. Portfolio interest constitutes interest on debt held by a foreign person that is not a bank and owns less than 10 percent (by vote) of the US debtor (including options, convertible debt, etc., on an as-converted basis).

Generally, no US WHT is imposed on interest accruals until the US debtor pays the interest or the foreign person sells the debt instrument. Thus, US WHT on interest may be deferred on zero coupon bonds or debt issued at a discount, subject to certain limitations discussed below (see 'Discounted securities').

Checklist for debt funding

— Debt should be borne by US debtors that are likely to have adequate positive cash flows to service the debt principal and interest payments.

— Debt should satisfy the various factors of indebtedness to avoid being reclassified as equity.

— Debt must be adequately collateralized to be treated as genuine indebtedness of the issuer.

— The interest expense must qualify as deductible under the various rules limiting interest deductions discussed earlier.

— Debt between related parties must be issued under terms that are consistent with arm's length standards.

— Guarantees or pledges on the debt may be subject to the earnings-stripping rules or current income inclusion rules under the subpart F rules.

Equity

The acquisition of a US target may be financed by issuing common or preferred equity. Distributions may be classified as dividends where paid out of the US target's current or accumulated earnings and profits (E&P; similar to retained earnings). Distributions in excess of E&P are treated as the tax-free recovery of tax basis in the stock (determined on a shares-by-share basis). Distributions exceeding both E&P and stock basis are treated as capital gains to the holder.

US issuers of stock interests generally are not entitled to any deductions for dividends paid or accrued on the stock. Generally, US individual stockholders are subject to tax on dividends from a US target based on their overall income tax bracket (see 'Pre-sale dividends' for the applicable tax rates). Stockholders who are US corporations are subject to tax at the 21 percent rate applicable to corporations, but they are entitled to DRDs when received from US corporations depending on their ownership interest (see 'Pre-sale dividends').

Generally, dividends paid to a foreign shareholder are subject to US WHT at 30 percent unless eligible for favorable WHT rates under a US treaty. The WHT rules provide limited relief for US issuers that have no current or accumulated E&P at the time of the distribution and anticipate none during the tax year. Such a US issuer may elect out of the WHT obligation where, based on reasonable estimates, the distributions are not paid out of E&P.

Generally, no dividend should arise unless the issuer of the stock declares a dividend or the parties are required currently to accrue the redemption premium on the stock under certain circumstances. Of course, US WHT is also imposed on US-source constructive (i.e. deemed paid) dividends. For example, where a subsidiary sells an asset to its parent below the asset's fair market value, the excess of the fair market value over the price paid by the parent could be treated as a constructive dividend.

Generally, gains from stock sales (including redemptions) are treated as capital gains and are not subject to US WHT (but see the discussion of FIRPTA earlier in this report). Certain stock redemptions may be treated as giving rise to distributions (potentially treated as dividends) where the stockholder still holds a significant amount of stock in the corporation post-redemption of either the same class or another class(es). Accordingly, the redemption may result in ordinary income for the holder that is subject to US WHT. See this report's sections on 'Purchase of assets' and 'Purchase of shares' for discussion of certain tax-free reorganizations.

Hybrid instruments and entities

Instruments (or transactions) may be treated as indebtedness (or a financing transaction) of the US issuer, while receiving equity treatment under the local (foreign) laws of the counterparty. This differing treatment may result in an interest deduction for the US party while the foreign party benefits from the participation exemption or FTCs that reduce its taxes under local law. Alternatively, an instrument could be treated as equity for US tax purposes and as debt for foreign tax purposes.

Similarly, an entity may be treated as a corporation for US tax purposes and a transparent entity for foreign tax purposes (or vice versa). Under certain circumstances, this differing treatment can give rise to 'stateless income' (income that is taxed nowhere).

As noted in 'Recent developments', certain provisions of the 2017 Tax Law seek to discourage use of hybrid entities and instruments that give rise to stateless income. Specifically, the 2017 Tax Law contains a new 'hybrid mismatch rule' that generally disallows deductions for related-party interest or royalties paid or accrued in connection with certain hybrid transactions or by, or to, hybrid entities if (i) the related party does not have a corresponding income inclusion under local tax law; or (ii) such related party is allowed a deduction with respect to the payment under local tax law. This provision, which incorporates the concepts of the OECD BEPS Action 2, applies to tax years beginning after 31 December 2017.

For purposes of this hybrid mismatch rule, a hybrid transaction includes any transaction or instrument under which one or more payments are treated as interest or royalties for US federal income tax purposes but are not treated as such under the local tax law of the recipient. A hybrid entity is one that is treated as fiscally transparent for US federal income tax purposes (e.g. a disregarded entity or partnership) but not for purposes of the foreign country of which the entity is resident or is subject to tax (hybrid entity), or an entity that is treated as fiscally transparent for foreign tax law purposes but not for US federal income tax purposes (reverse hybrid entity). The 2017 Tax Law provides broad regulatory authority for Treasury and the IRS to subject additional transactions to this new hybrid mismatch rule.

The hybrid mismatch rule eliminates the US tax benefits of some hybrid structures that foreign multinationals have commonly used in the past to finance US operations. Foreign multinationals should consider revisiting their US inbound financing structures in view of the new hybrid mismatch rule and also consider this rule when determining the acquisition funding structure for US target companies.

Buyers of US target companies should also carefully consider the OECD BEPS recommendations concerning hybrids during the tax due diligence phase and before implementing any structures concerning acquisition finance planning and/or acquisition integration planning. Where hybrid instruments and entities are concerned, a number of jurisdictions (e.g. the Netherlands) have already implemented some of the OECD's BEPS recommendations that undo some of the tax benefits of hybrid structures commonly implemented by US multinationals, and several other jurisdictions have proposed adopting the OECD recommendations. It is important to keep this in mind when acquiring a US multinational that has significant operations in such jurisdictions.

In addition to the new hybrid mismatch rule, the 2017 Tax Law also precludes CFC hybrid dividends from qualifying for the DRD. The 2017 Tax Law broadly defines the term 'hybrid dividend' to mean a payment for which a CFC receives a deduction or other tax benefit in a foreign country. The 2017 Tax Law generally treats hybrid dividends between tiered CFCs as subpart F income. Despite this subpart F income treatment, the 2017 Tax Law does not allow utilization of foreign tax credits resulting from hybrid dividends.

Discounted securities

A US issuer may issue debt instruments at a discount to increase the demand for its debt instruments. The issuer and the holder are required currently to accrue deductions and income for the original issue discount (OID) accruing over the term. However, a US issuer may not deduct OID on a debt instrument held by a related foreign person unless the issuer actually paid the OID.

A corporate issuer's deduction for the accrued OID may be limited (or even disallowed) where the debt instrument is treated as an applicable high yield discount obligation (AHYDO). In that case, the deduction is permanently disallowed for some or all of the OID if the yield on the instrument exceeds the applicable federal rate (for the month of issuance) plus 600 basis points. Any remaining OID is only deductible when paid.

Deferred settlement

In certain acquisitions, the parties may agree that the payment of a part of the purchase price should be made conditional on the target meeting pre-established financial performance goals after the closing (earn-out). Where the goals are not met, the buyer can be relieved of some or all of its payment obligations. An earn-out may be treated as either the payment of the contingent purchase price or ordinary employee compensation (where the seller is also an employee of the business). Buyers generally prefer to treat the earn-out as compensation for services, so they can deduct such payments from income.

In an asset acquisition, the buyer may capitalize the earn-out payment into the assets acquired but only in the year such earn-out amounts are actually paid. Such capitalized earn-out amounts should be depreciated/amortized over the remaining depreciable/amortizable life of the applicable assets. In a stock acquisition, the earn-out generally adds to the buyer's basis in the target stock. Interest may be imputed on deferred earn-out payments unless the agreement specifically provides for interest.

Other considerations

Documentation

Documentation of each step in the transaction and the potential tax consequences is recommended. Taxpayers generally are bound by the form they choose for a transaction, which may have material tax consequences. However, the government may challenge the characterization of a transaction on the basis that it does not reflect its substance. Thus, once parties have agreed on the form of a transaction, they are well advised to document the intent, including the applicable Code sections. Parties should also maintain documentation of negotiations and appraisals for purposes of allocating the purchase price among assets.

Contemporaneous documentation of the nature of transaction costs should also be obtained. Although the parties to a transaction generally cannot dictate the tax results through the contract, documentation of the parties' intent can be helpful should the IRS challenge the characterization of the transaction.

Concerns of the seller

Generally, the seller's tax position influences the structure of the transaction. The seller may prefer to receive a portion of the value of the target in the form of a pre-sale dividend for ordinary income treatment or to take advantage of DRDs. A sale of target stock generally results in a capital gain, except in certain related-party transactions (see 'Purchase of shares') or on certain sales of shares of a CFC. In addition, a foreign seller of a USRPHC may be subject to tax and withholding based on FIRPTA, as discussed earlier in this report.

A sale of assets could also result in capital gains treatment except for depreciation recapture, which may have ordinary income treatment. Where the seller has no tax attributes to absorb the gain from asset sales, gains may be deferred where the transaction qualifies as a like-kind exchange, in which the seller exchanges property for like-kind replacement property (e.g. exchange of real estate). As previously mentioned, it seems likely that the seller of a US target company may be more willing to sell assets than before due to the US corporate tax rate reduction and 100 percent expensing for qualifying purchases of depreciable tangible property. Under the 2017 Tax Law, a C corporation that sells an asset and reinvests the proceeds into qualifying depreciable tangible property receives a cash tax benefit due to acceleration of deductions.

Alternatively, the transaction may be structured as a tax-free separation of two or more existing active trades or businesses formerly operated, directly or indirectly, by a single corporation for the preceding 5 years (spin-off). Stringent requirements must be satisfied for the separation to be treated as a tax-free spin-off.

Company law and accounting

This discussion is a high-level summary of certain accounting considerations associated with business combinations and non-controlling interests.

Accounting Standards Codification (ASC) Topic 805, *Business Combinations* (ASC 805) and ASC Subtopic 810-10, *Consolidations — Overall* (ASC 810-10) require most identifiable assets acquired, liabilities assumed and non-controlling interest in the acquiree to be recorded at 'fair value' in a business combination and require non-controlling interests to be reported as a component of equity.

ASC 805-10-20 defines a 'business combination' as a transaction or other event in which an entity (the acquirer) obtains control of one or more businesses (the acquiree or acquirees). A business combination may occur even where control is not obtained by purchasing equity interests or net assets, as in the case of control obtained by contract alone. This can occur, for example, when a minority shareholder's substantive participating rights expire and the investor holding the majority voting interest gains control of the investee.

ASC 805-10-55-3A defines a business as an integrated set of activities and assets that is capable of being conducted and managed to provide a return in the form of dividends, lower costs, or other economic benefit directly to investors or other owners, members or participants.

On 5 January 2017, the Financial Accounting Standards Board (FASB) issued Accounting Standard Update (ASU) No. 2017-01, *Clarifying the Definition of a Business* (ASU 2017-01), which provides a new framework for determining whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. Under ASU 2017-01, an integrated set of activities and assets is a business if it has, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. The ASU creates a screening test that reduces the population of transactions that an entity needs to analyze to determine whether there is an input and a substantive process. ASU 2017-01 is effective for public business entities for annual and interim periods in fiscal years beginning after 15 December 2017 (i.e. 1 January 2018 for public companies with a calendar year-end). For all other entities, it is effective for annual periods in fiscal years beginning after 15 December 2018, and interim periods in fiscal years beginning after 15 December 2019. An entity may adopt the ASU early and apply it to transactions that have not yet been reported in financial statements that have been issued or made available for issuance.

Business combinations are accounted for by applying the acquisition method. Companies applying this method must:

— identify the acquirer

— determine the acquisition date and acquisition-date fair value of the consideration transferred, including contingent consideration

— recognize, at their acquisition-date fair values, the identifiable assets acquired, liabilities assumed and any non-controlling interests in the acquiree

— recognize goodwill or, in the case of a bargain purchase, a gain.

ASC 805 allows for a measurement period for the acquirer to obtain the information necessary to enable it to complete the accounting for a business combination. Until necessary information can be obtained, and for no longer than 1 year after the acquisition date, the acquirer reports provisional amounts for the assets, liabilities, equity interests or items of consideration for which the accounting is incomplete.

A company that obtains control but acquires less than 100 percent of an acquiree records 100 percent of the acquiree's assets (including goodwill), liabilities and non-controlling interests, measured at fair value with few exceptions, at the acquisition date.

ASC 810-10 specifies that non-controlling interests are treated as a separate component of equity, not as a liability or other item outside of equity. Because non-controlling interests are an element of equity, increases and decreases in the parent's ownership interest that leave control intact are accounted for as equity transactions (i.e. as increases or decreases in ownership) rather than as step acquisitions or dilution gains or losses.

The carrying amount of the non-controlling interests is adjusted to reflect the change in ownership interests.

Any difference between (i) the fair value of the consideration received or paid and (ii) the amount by which the non-controlling interest is adjusted is recognized directly in equity attributable to the parent (i.e. additional paid-in capital).

A transaction that results in the loss of control generates a gain or loss comprising a realized portion related to the portion sold and an unrealized portion on the retained non-controlling interest, if any, that is re-measured to fair value. Similarly, a transaction that results in the gain of control could result in a gain or loss on previously held equity interests in the investee since the acquirer would account for the transaction by applying the acquisition method on that date.

Group relief/consolidation

Affiliated US corporations may elect to file consolidated federal income tax returns as members of a consolidated group. Generally, an affiliated group consists of chains of 80 percent-owned (by vote and value) corporate subsidiaries (members) having a common parent that owns such chains directly or indirectly.

The profits of one member may be offset against the current losses of another member. In most cases, gains or losses from transactions between members are deferred until the participants cease to be members of the consolidated group or otherwise cease to exist. Complex rules may limit the use of losses arising from the sale of stock of a member to unrelated third parties (i.e. unified loss rules).

Transfer pricing

Following an acquisition of a target, all transactions between the buyer and the target must be consistent with arm's-length standards. If related parties fail to conduct transactions at arm's length, the IRS may reallocate gross income, credits, deductions or allowances between the participants to prevent tax avoidance or to reflect income arising from such transactions. As stated earlier, such transactions may include loans, sales of goods, leases or licenses. Contemporaneous documentation must be maintained to support intercompany transfer pricing policies.

Dual residency

Generally, the NOLs of a dual resident corporation (DRC) and a net loss attributable to a separate unit cannot be used to offset the taxable income of a US affiliate or the domestic corporation that owns the separate unit. Any such loss is a dual consolidated loss (DCL) subject to regulations contained in Treas. Reg. 1.1503(d)-1 through 8.

A DRC is a domestic corporation subject to income tax in a foreign country on a worldwide income basis or as a resident of the foreign country. A separate unit is a foreign branch or a hybrid entity (i.e. an entity not subject to tax in the US but subject to tax in a foreign country at the entity level) that is either directly owned by a domestic corporation or indirectly owned by a domestic corporation through a partnership, trust or disregarded entity.

Limited use of a DCL may be possible where the consolidated group or domestic corporation (in the case of a stand-alone domestic corporation) files a special election that ensures that amounts deducted in computing the DCL will not be used to offset the income of a foreign person.

Foreign investments of a US target company

Often, a US target owns shares of one or more foreign corporations. As discussed above, the 2017 Tax Law makes fundamental changes to the taxation of US multinationals and their foreign subsidiaries. Under the old law, the earnings of foreign subsidiaries generally were not subject to US income tax until the earnings were repatriated through dividend distributions. Foreign subsidiary earnings generally were subject to immediate US taxation only if the earnings were subject to the US subpart F anti-deferral rules. Under the new law, the earnings of foreign subsidiaries are either subject to immediate taxation under expanded anti-deferral provisions or permanently exempt from US taxation. The new law generally retains the existing subpart F regime, and it creates a new, broad class of income ('global intangible low-taxed income' or 'GILTI') that is also subject to immediate taxation. Under a new participation exemption system, earnings of foreign subsidiaries that are not subject to tax under the subpart F or GILTI regimes generally are exempt from US tax when distributed to a US shareholder as a dividend. In many cases, however, most foreign subsidiary earnings will be subject to tax either as subpart F income or GILTI.

Foreign buyers of US companies should carefully consider the subpart F and GILTI rules when undertaking acquisition integration planning for US targets that have foreign subsidiaries. As indicated above, when applicable, the subpart F rules accelerate US taxation of certain income (subpart F income) earned by a CFC. For purposes of the subpart F rules, a CFC is any foreign corporation more than 50 percent of whose stock (by vote or value) is owned by US shareholders (as defined below) on any day during the taxable year of the foreign corporation. Subpart F income generally includes passive income (e.g. dividends, interest, royalties, rents, annuities, gains from sales of property), and related-party sales and services income. Under the subpart F rules, subpart F income earned by a CFC may be currently included in the income of a US target that is a 'US shareholder' of the CFC, even if the CFC has not distributed the income.

The 2017 Tax Law expands the reach of the subpart F rules through the following changes:

— The 2017 Tax Law eliminates a constructive ownership rule that previously prevented downward stock attribution from foreign shareholders to US corporations. Under the 2017 Tax Law, a US subsidiary of a foreign parent company may be attributed ownership of stock of a foreign subsidiary owned by the foreign parent. As a result, the foreign subsidiary may be treated as a CFC and, thus, subject to the subpart F and GILTI rules. Note, however, that the US subsidiary would not have an income inclusion with respect to the foreign subsidiary, unless the US subsidiary directly or indirectly owns 10 percent or more of the foreign subsidiary stock. Nevertheless, as discussed in further detail below and subject to further guidance from the IRS, the US subsidiary may also be subject to additional informational reporting requirements that did not apply pre-tax reform. The new downward attribution rules apply to the last tax year of foreign corporations beginning before 1 January 2017.

— The 2017 Tax Law expands the 'US shareholder' definition to include US persons that own directly, indirectly, or

constructively stock representing 10 percent or more of the 'value' or voting power of a foreign corporation. The test for 'US Shareholder' status previously was based solely on ownership of 'voting power'. This expanded definition of 'US shareholder' applies for taxable years of foreign corporations that begin after 31 December 2017.

— Effective for tax years beginning after 31 December 2017, the 2017 Tax Law eliminates the 30-day CFC minimum holding period for exposure to subpart F inclusions.

As indicated above, the 2017 Tax Law introduces a new anti-deferral regime that requires a US shareholder of a CFC to include its GILTI in income. Most foreign subsidiary earnings that had been eligible for deferral under the old law are now subject to immediate US income taxation under the new GILTI provision. Corporate shareholders are allowed a deduction equal to 50 percent of GILTI for 2018 through 2025, which will be decreased to 37.5 percent beginning in 2026. As a result, the effective tax rate on GILTI for a US corporate shareholder is 10.5 percent prior to 2026, and 13.125 percent after 2026. A US corporation's GILTI deduction, however, may be limited when its GILTI and foreign-derived intangible income amounts (discussed below) exceed the corporation's taxable income.

In general, GILTI is the excess of all of the US corporation's net income over a deemed return on the CFC's tangible assets (10 percent of depreciated tax basis). In many situations, most of a CFC's gross income that is not subject to current taxation under the existing subpart F regime will be subject to immediate taxation as GILTI. The generally small sliver of income represented by the permitted return on tangible assets is not subject to US taxation when earned by the foreign subsidiary and, as discussed above, is eligible for a 100 percent dividends received deduction (DRD). A credit is also allowed for 80 percent of foreign taxes paid.

Although lowering the US statutory rate from 35 percent to 21 percent presumably reduces incentives to shift profits outside the US, the GILTI provision reflects a concern that a shift to a territorial tax system could exacerbate those incentives because any profits shifted offshore would be permanently exempt from US tax. The inclusion of GILTI in a US shareholder's income is intended to reduce those incentives by ensuring at least a minimal rate of tax, at least on those earnings of CFCs that exceed the permitted return on tangible assets.

The foreign earnings of a CFC that are not subject to tax under the subpart F or GILTI regimes generally are exempt from US taxation. Under the 2017 Tax Law's participation exemption regime, a US target corporation is allowed a 100 percent DRD on dividends received from a foreign subsidiary, subject to certain conditions being met. As a general matter, the 100 percent DRD is only available to US C corporations and is limited to the foreign-source portion of dividends received from a foreign corporation in which the US corporation is a US shareholder (i.e. the US corporation owns 10 percent or more of the vote or value of the foreign corporation's stock).

In addition to the subpart F and GILTI regimes, the US tax code also contains anti-deferral rules that govern passive foreign investment companies (the so-called 'PFIC' regime). A US target may be subject to taxation and interest charges resulting from owning stock in a PFIC. A PFIC is any foreign corporation (that is not a CFC) that satisfies either of the following income or asset tests:

— at least 75 percent of its gross income for the taxable year consists of certain passive income

— at least 50 percent of the average percentage of assets consists of assets that produce certain passive income.

A US target owning PFIC stock is subject to a tax and interest charge on gains from the disposal of PFIC stock or receipt of an excess distribution from a PFIC. To avoid the PFIC tax regime, the US target may elect to treat the foreign corporation as a qualified electing fund (QEF election), with the US target being currently taxed on the QEF's earnings and capital gain, or elect to recognize the built-in gain in the PFIC stock under a mark-to-market election.

During the acquisition planning phase, foreign buyers of US multinationals should consider whether it may be beneficial for the US target company to undertake any pre-acquisition restructuring that involves moving foreign subsidiaries of the US target out from under the US target. Any pre-acquisition restructuring will require the cooperation of the seller. Failure to undertake timely out-from-under planning to unwind such a 'sandwich structure' can indirectly expose the foreign buyer to additional US taxes (and, therefore, a higher global effective tax rate) due to application of the subpart F, GILTI, and/or PFIC rules. If out-from-under planning is not undertaken prior to the acquisition, then the foreign buyer should consider out-from-under planning as part of its overall post-acquisition integration planning initiative for US target.

From a tax due diligence perspective, foreign buyers of US target companies should also confirm with the seller whether the US target filed all required Forms 5471, *Information Return of US Persons with Respect to Certain Foreign Corporations*, with respect to its CFCs. To provide a little background, the United States generally requires that 'US shareholders' of a CFC file with their US federal income tax returns a Form 5471 for each CFC.[1] On Form 5471, a US shareholder reports (among other things):

— certain financial information for a CFC

— a CFC's E&P; and

— a CFC's transactions with related parties.

[1] In January 2018, the IRS released a notice that signals relief from Form 5471 filing obligations for CFCs created by downward attribution (previously discussed). In this notice, the IRS stated its intentions to amend the Form 5471 instructions to except US shareholders from Form 5471 filing obligations if the US shareholders only own CFC stock via the constructive ownership rules as a result of the 2017 Tax Law changes to section 958(b)(4)).

During the tax due diligence phase, it is very important that a foreign buyer of a US target company consider whether the US target appropriately prepared and filed any required Forms 5471. In addition to penalties, the failure to file a Form 5471 or substantially complete the Form 5471 may cause the US target's statute of limitations (typically 3 years) to be extended indefinitely.

Integration planning for US target-owned intellectual property

Acquisition integration planning often includes identifying alternatives for the tax-efficient transfer of target company IP to the buyer's existing IP holding company structure. Following the 2017 Tax Law and other recent changes to the US Treasury regulations, a US corporation will be subject to US taxation on any transfer of IP to a foreign corporation. This includes a transfer of goodwill, going concern value, or workforce in place.[2] The 2017 Tax Law also contains provisions that are either intended to reduce the incentives for a company to reduce its US tax base (e.g. the GILTI and BEAT provisions, as discussed in this report or to encourage IP shifts into the United States (e.g. the so-called FDII regime, discussed in more detail below).

As a complement to the new GILTI regime that imposes a minimum tax on excess returns earned by a CFC, the 2017 Tax Law provides a 13.125 percent effective tax rate (increasing to 16.406 percent in 2026) on 'foreign-derived intangible income' (FDII) earned directly by a US corporation from foreign sales, leases, licenses, and services to unrelated foreign persons. Presumably, the goal of the FDII provision is to provide an incentive for US companies to locate productive assets in the United States, rather than offshore.

As in the GILTI regime, the reduced effective tax rates for FDII are achieved through a special deduction by the US corporation. At a high level, a US corporation's FDII is its net income from export activities reduced by a fixed 10 percent return on its depreciable assets used to generate the export income. A US corporation's FDII deduction may be limited, however, when its GILTI and FDII amounts exceed the corporation's taxable income.

Together with the reduced US corporate tax rate of 21 percent and the GILTI regime, the FDII regime generally makes the US, as compared to before, a more attractive option for the establishment of an export base and may reduce the incentives for US companies to transfer or keep IP offshore.

The table below summarizes the impact of the GILTI and FDII provisions on US effective tax rates. The effective tax rates noted in this table take into account the new US corporate tax rate of 21 percent and, in the case of the effective tax rate noted for GILTI, an 80 percent foreign tax credit. The rates also rely on several assumptions that may not be true in many cases. For example, these rates assume that the US taxpayer in question has sufficient income to take the full GILTI deduction which may not be true due to current year losses or NOL carryforwards. As of January 2018, several European countries have expressed their intentions to challenge the FDII regime. Representatives from these countries claim that the FDII regime is not in line with the international norms on patent boxes and violates international trade rules on export subsidies.[3] As of January 2018, the long-term viability of the FDII regime appears uncertain.

GILTI	2018–2025	2026 and after
Deduction	50 percent	37.5 percent
Effective US tax rate	10.5 percent	13.125 percent
Minimum foreign tax rate at which US residual tax = 0[4]	13.125 percent	16.406 percent
FDII		
Deduction	37.5 percent	21.875 percent
Effective US tax rate	13.125 percent	16.406 percent

As previously noted, the 2017 Tax Law eliminates the so-called goodwill exception that many companies previously relied upon to tax efficiently integrate target company IP with buyer's existing IP holding company structure. To effect this change, the 2017 Tax Law broadens the definition of 'intangible property' by amending section 936(h)(3)(B) to say the following, among other things, constitute 'intangible property':

— any goodwill, going concern value, or workforce in place (including its composition and terms and conditions (contractual or otherwise) of its employment)

— any other item the value or potential value of which is not attributable to tangible property or the services of any individual.

The 2017 Tax Law's broader definition of intangible property, which is in line with the OECD's definition of intangible, is intended to prevent the use of intangible property transfers to shift income between related parties, and more specifically, to make it more difficult for a US person to make an outbound transfer of intangible property without incurring tax.

[2] Before the 2017 Tax Law was enacted, the Treasury Department and IRS issued in September 2015 temporary regulations (T.D. 9738) under section 482 (the 'US transfer pricing rules') and, by cross-reference, new proposed regulations under section 367. These proposed regulations sought to significantly limit the application of the foreign goodwill exception. The 2017 Tax Law contains provisions that carry out the intent of these proposed regulations.

[3] Letter from Federal Ministry of Finance, to Steven Mnuchin, Secretary, Department of the Treasury (11 December 2018).

[4] As a general matter, a US shareholder's ability to utilize foreign tax credits may be limited by allocable expenses. Because the US foreign tax credit limitation rules apply to foreign taxes associated with the GILTI calculation, the elimination of any US residual tax assumes (perhaps unrealistically) that no expenses are properly allocable against the GILTI inclusion, which might limit the shareholder's ability to utilize all of the GILTI-related foreign tax credits.

Finally, in addition to the provisions discussed above, it is important that foreign buyers of US target companies consider the 2017 Tax Law's hybrid mismatch rule and base erosion anti-avoidance tax (BEAT) provision before implementing any transfers of IP owned by a US target company or its subsidiaries. As previously mentioned, the hybrid mismatch rule generally disallows deductions for related-party interest or royalties paid or accrued in connection with certain hybrid transactions or by, or to, hybrid entities if (i) the related party does not have a corresponding income inclusion under local tax law; or (ii) such related party is allowed a deduction with respect to the payment under local tax law. For additional details regarding the hybrid mismatch rule, see 'Hybrid instruments and entities'.

Very generally, the BEAT is an additional tax that applies to large corporations that reduce their US tax liabilities below a certain threshold by making deductible payments (e.g. interest and royalties) to related foreign entities. If applicable, a US corporation will have a BEAT liability in addition to its regular income tax liability.

The BEAT generally applies to corporations that are not S corporations, RICs, or REITs, are part of a group with at least US$500 million of annual domestic gross receipts (over a 3-year averaging period), and that have a 'base erosion percentage' of 3 percent or higher (2 percent for certain banks and securities dealers). The base erosion percentage generally is determined by dividing deductions attributable to payments to related foreign persons by the total amount of the corporation's deductions for the year.

Corporations that meet the US$500 million gross receipts test and the base erosion percentage are required to run a separate set of calculations to determine whether they are subject to a BEAT liability. The BEAT regime generally requires a taxpayer to recompute its taxable income as if it had not made any base erosion payments and then multiplies that 'modified taxable income' amount by the applicable BEAT tax rate. The taxpayer generally will have a BEAT liability to the extent that amount exceeds the taxpayer's post-credit regular tax liability (the BEAT rules provide preferential treatment for four types of tax credits).

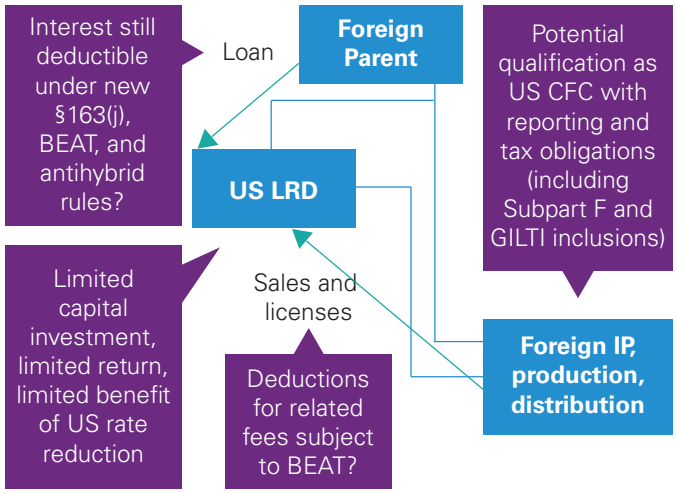
The BEAT tax rate generally is 5 percent for 2018, 10 percent for 2019–2025, and 12.5 percent after 2025. The BEAT rate is 1 percent higher for banks and registered securities dealers.

Due to the new BEAT regime, many foreign multinationals that receive substantial royalty, interest or service payments from US subsidiaries could see an increase in their effective tax rate. Companies subject to the BEAT may need to consider supply chain restructuring if the BEAT gives rise to an unmanageable cost that detrimentally impacts the company's competitiveness. For some companies, such restructuring to address BEAT exposures may include, for example, converting a service fee procurement company structure into a buy-sell structure and/or transferring customer contracts to foreign subsidiaries. The restructuring options chosen will depend on each taxpayer's particular facts, circumstances, and operational goals. During the tax due diligence phase, foreign buyers of US target companies should consider the extent to which a target company's intercompany transactions are subject to the new BEAT regime. Unlike the GILTI regime, the BEAT applies to all US taxpayers that satisfy the US$500 million threshold test regardless of whether part of a US or non-US group.

Other acquisition integration planning considerations from a value chain perspective

Most of the 2017 Tax Law's international tax provisions apply equally to US and foreign multinationals that have US operations. For example, depicted below is a common structure (Diagram 1) that may no longer be optimal due to US tax reform developments (in the diagram below, LRD is a limited risk distributor). When performing tax due diligence, acquiring companies should carefully consider whether the target's structure is detrimentally impacted by US tax reform developments.

Diagram 1:



Foreign Parent, the ultimate corporate parent of a multinational corporate group, has IP, manufacturing and R&D offshore and sells to the US market via a captive US LRD

Tax Reform Considerations

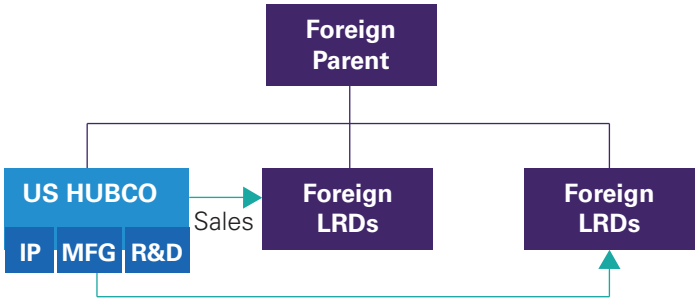
— Lower US corporate tax rate facilitates higher profits in the United States.

— Immediate expensing of capital assets and survival of the R&E credit facilitate expansion of US risks and activities (and BEAT potentially penalizes keeping IP offshore).

— With respect to US market sales, Foreign Parent's global profits are expected to be taxed at a rate closer to 21 percent.

— Low tax attributable to US IP under IP incentives regime could facilitate US production and export model.

Diagram 2: Alternative future structure? (whether this structure makes sense heavily depends on company-specific facts)



Considerations from an OECD BEPS initiative perspective

It is important that foreign buyers of US companies consider not only US tax reform developments but also global BEPS developments when planning the acquisition of a US company. Consideration of country-specific BEPS developments is especially important when completing tax due diligence reviews, defining tax indemnities, and undertaking acquisition integration planning. As of January 2018, the US has implemented some but not all of the OCED BEPS recommendations. Even if the US implements no additional OECD BEPS recommendations in the future, it is important that foreign buyers of US companies consider BEPS issues when planning the acquisition of a US company due to the following reasons:

— US companies often have foreign subsidiaries located in jurisdictions that have already implemented some or all of the OECD's BEPS recommendations

— implementation of the OECD's BEPS recommendations by other countries can impact the tax cost of financing the acquisition of US target companies and value chain operational changes.

Where acquisition financing is concerned, certain OECD BEPS recommendations raise tax exposure concerns for a number of common US inbound acquisition financing structures (e.g. US inbound acquisition financing structures involving Luxembourg entities).

From a tax due diligence perspective, areas of key focus from a BEPS perspective include, for example, consideration of whether the US target company has any structures in place that include: hybrid entities (e.g. an entity that is treated as a corporation for US tax purposes but as a disregarded entity for foreign tax purposes), hybrid instruments (e.g. an instrument that is treated as debt in the payor jurisdiction and equity in the recipient jurisdiction), hybrid transfers (e.g. a repo transaction treated as a secured financing in one jurisdiction and as a sale and repurchase in another), principal companies, limited risk distributors, commissionaires, and IP license and/or cost sharing arrangements. As it concerns identifying BEPS exposures during the tax due diligence phase, other important considerations also include consideration of local country tax rulings obtained by the target company, if any, in various jurisdictions. In the current environment, structures that include elements such as those just listed and/or local country tax rulings present the risk of increased audit scrutiny and tax authority challenges.

Once BEPS exposures are identified, it is important for both the acquiring company and target company to determine a course of action. One possible approach may be for the seller of the target company to give the acquiring company a purchase price reduction in anticipation that the buyer will incur future 'BEPS unwind costs'. Alternatively, another approach may involve the target company addressing the BEPS exposures through pre-acquisition structuring. As a general matter, buyers should consider any BEPS exposures specific to both the target and acquiring companies' structures during the acquisition integration planning phase.

As previously discussed, various provisions of the 2017 Tax Law (e.g. the new hybrid mismatch rule) incorporate certain OECD BEPS recommendations. Also, noteworthy, the updated US model income tax treaty released in 2016 (the 2016 Model Treaty) includes some BEPS-like provisions. For example, the 2016 Model Treaty includes provisions that would deny treaty benefits on deductible payments of mobile income made to related persons where that income benefits from low or no taxation under a preferential tax regime.

Net investment income tax

Section 1411 imposes a 3.8 percent tax on net investment income (NII) of individuals, estates and trusts with gross income above a specified threshold. The NII tax does not apply to S or C corporations, partnerships (but may apply to their owners), non-resident aliens, tax-exempt trusts (e.g. charitable trusts), and trusts that are not classified as trusts under the Code (e.g. REITs).

In the case of an individual, the NII tax is applied on the lesser of the NII or the excess of gross income thresholds as follows:

Filing status	Threshold amount
Married, filing jointly or a surviving spouse	US$250,000
Married, filing separately	US$125,000
Other	US$200,000

Source: Code section 1411(b)

NII includes three major categories of income:

1. interest, dividend, annuities, royalties and rents (unless derived in a trade or business)

2. income from passive trades or businesses and from the business of trading financial instruments and commodities; and

3. net gains from the disposition of property other than property held in a trade or business.

The NII tax is computed on Form 8960, Net Investment Income Tax — Individuals, Estates, and Trusts. Individuals report this tax on Form 1040, US Individual Income Tax Return. Estates and trusts report this tax on Form 1041, US Income Tax Return for Estates and Trusts.

The 2017 Tax Law leaves the 3.8 percent NII tax in place.

Foreign Account Tax Compliance Act

The Foreign Account Tax Compliance Act (FATCA) was enacted into law to address tax evasion by US taxpayers that hold unreported assets in non-US financial accounts and undisclosed interests in foreign entities. Generally, FATCA affects three groups:

1. foreign financial institutions (FFI)
2. non-financial foreign entities (NFFE)
3. withholding agents.

FFIs are required to identify their US account holders, obtain and track those account holders' tax information, and report it annually to the IRS (or to local authorities for FFIs operating in jurisdictions that have signed a Model 1 Intergovernmental Agreement). NFFEs are generally required to identify and disclose their substantial US owners, unless they qualify for an exception (e.g. where the NFFE is an 'Active NFFE').

FATCA applies a 30 percent tax (effectively a penalty) that is enforced by withholding agents, who must generally withhold 30 percent from certain payments of US-source fixed, determinable, annual or periodical income (FDAP) made to noncompliant entities. Payments of gross proceeds from the disposition of property that give rise to US-source dividends and interest that are paid to noncompliant entities are also subject to the 30 percent withholding tax for dispositions occurring after 31 December 2018.

The 30 percent withholding tax may be eliminated in several ways. The simplest way is for the payee to be a type of entity that is not subject to withholding and for such payee to provide a properly completed withholding certification (e.g. Form W-8BEN-E, Certificate of Status of Beneficial Owner for United States Tax Withholding and Reporting (Entities)), to the withholding agent identifying itself as an FATCA compliant entity (e.g. a participating FFI or active NFFE).

FATCA exempts certain payments from withholding (e.g. so-called 'non-financial payments'). In this case, the withholding agent must independently determine whether the payment otherwise subject to withholding qualifies for an exception.

FATCA imposes secondary liability on withholding agents for failure to properly withhold.

The payment of US-source FDAP to a non-US person must be reported on Form 1042-S, Foreign Person's US Source Income Subject to Withholding, and Form 1042, Annual Withholding Tax Return for US Source Income of Foreign Persons.

Comparison of asset and share purchases

Advantages of asset purchases

— The purchase price may be depreciated or amortized for tax purposes. Also, if certain conditions are met, the 2017 Tax Law allows a 100 percent deduction for the cost of qualified property (generally tangible depreciable property with a depreciation life of less than 20 years) acquired from unrelated persons and placed in service after 27 September 2017, and before 1 January 2023. The 2017 Tax Law includes a 20 percent increment phase-down of the 'bonus' depreciation percentage for property acquired after 2022.[5]

— Previous liabilities (including income tax liabilities) of the target generally are not inherited.

— Possible to acquire only part of a business.

— Profitable operations can be absorbed by loss companies in the buyer's group, thereby effectively gaining the ability to use the losses, subject to any applicable limitations.

Disadvantages of asset purchases

— May need to renegotiate supply, employment and technology agreements, and change stationery.

— A higher capital outlay is usually involved (unless debts of the business are also assumed).

— May be unattractive to the seller, thereby increasing the price.

— The transaction may be subject to state and local transfer taxes.

— Benefit of any losses incurred by the target remains with the seller.

Advantages of share purchases

— Lower capital outlay (purchase net assets only).

— May be more attractive to seller, so the price could be lower.

— Buyer may benefit from tax losses of the target (subject to certain limitations).

— Buyer may benefit from existing supply or technology contracts.

[5] Specifically, the 2017 Tax Law allows businesses to expense 80 percent, 60 percent, 40 percent and 20 percent of the cost of property placed in service in 2023, 2024, 2025 and 2026, respectively. For additional details, see 'Depreciation and amortization'.

Disadvantages of share purchases

— Acquire unrealized tax liability for depreciation recovery on difference between market and tax book value of assets.

— Liable for any claims or previous liabilities of the target.

— No deduction for the purchase price (assuming no section 338 or 336(e) election).

— Losses incurred by any companies in the buyer's group in years prior to the acquisition of the target cannot be offset against certain recognized built-in gains recognized by the target.

— The use of certain tax attributes of the target may be limited after the acquisition.

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Introduction

The Australian tax system is subject to ongoing legislative change and contains complex rules that, together with commercial and legal considerations, affect mergers and acquisition (M&A) transactions in Australia. Several significant developments in tax law have occurred since the last edition of this publication.

This report provides an overview of some recent developments and key Australian tax issues that are relevant for buyers and sellers in M&A transactions in Australia. This report also discusses the Australian accounting and legal context of M&A transactions and highlights some key areas to address when considering the structure of a transaction.

Recent developments

Tax reform has proceeded apace in recent years in Australia. Many of the implemented and proposed changes affect the M&A environment. The key areas of focus include the following.

Recently implemented changes

Diverted profits tax: As of 1 July 2017, the diverted profits tax (DPT) gives the Australian Taxation Office (ATO) more powers to deal with global groups that have 'diverted' profits from Australia to offshore associates in jurisdictions with a tax rate of less than 24 percent, using arrangements that have a 'principal purpose' of avoiding Australian income or withholding tax. The DPT can apply to both Australian inbound and outbound groups, where the global group has annual global income of 1 billion or more Australian dollars (AUD).

If the DPT applies, income tax is payable on the amount of the 'diverted profit' at a rate of 40 percent. There appears to be a risk that the mutual agreement procedure in Australia's tax treaties would be unavailable where DPT applies — in which case unalleviated double taxation would result.

Chevron case: While not a change in law, the recent decision in the *Chevron* case is significant from an Australian tax perspective. The case involved the transfer price applied to an AUD3.7 billion intercompany loan agreement used to fund development of gas reserves. The decision resulted in a AUD340 million tax bill for Chevron.

In the decision, the Full Federal Court applied a different approach to determining the characteristics of the hypothetical independent parties referred to in the transfer pricing law.

The implications of this revised approach are potentially significant for taxpayers as it would enable features of the taxpayer in the context of the multinational group to which it belongs to be taken into account. Acting inconsistently — or being perceived to act inconsistently — with internal company policies (e.g. to borrow externally at the lowest rate possible, to provide a parental guarantee for external borrowings by subsidiaries) would likely be problematic from a transfer pricing perspective.

Earn-out arrangements: The Australian government has introduced a bill that changes the capital gains tax (CGT) treatment of the sale and purchase of businesses involving certain earn-out rights. Where capital gains and losses arise in respect of 'look-through' earn-out rights, these changes retrospectively adjust the gain/loss for the seller. This treatment applies to earn-out arrangements entered into on or after 24 April 2015.

Previously, the ATO's position called for the valuation of all earn-out rights at the time they were provided. The old rules continue to apply to earn-out rights that do not meet the definition of 'look-through' earn-out rights.

Non-resident capital gains withholding tax: Withholding tax applies on capital gains of foreign sellers disposing of certain Australian real property interests under contracts entered into on or after 1 July 2016. As of 1 July 2017, these rules were amended to increase the CGT withholding rate for foreign tax residents to 12.5 percent (from 10 percent) and reduce the withholding threshold to AUD750,000 (from AUD2 million).

In practice, these obligations should be considered when negotiating and drafting sale and purchase agreements, including the insertion of new clauses and application for variation certificates. A buyer who fails to correctly withhold is exposed to penalties equal to the amount that was required to be withheld plus interest.

Management investment trusts: The Australian government enacted legislation for a new managed investment trust (MIT) tax regime with effect from 1 July 2015. MIT structures are commonly used by non-Australian residents who have invested in property assets. The proposals would introduce (among other things), an MIT attribution model to determine

income amounts taxable to the beneficiaries and broaden the test for the widely held ownership requirement in order to qualify as a MIT. These changes should improve the availability of the regime and provide greater certainty for investors. See 'Attribution MITs' later in this report.

Proposed changes

Hybrid mismatch rules: Exposure draft legislation has been released proposing to introduce rules targeted at 'hybrid mismatches', which include:

— hybrid financial instruments treated as debt in one jurisdiction and equity in another

— hybrid entities that are treated as taxable in one jurisdiction but as flow-through entities in another jurisdiction.

Such structures can give rise to double deductions (where deductions arise in more than one jurisdiction for the same payment) or deduction/non-inclusion outcomes (where payments are deductible in one jurisdiction but not assessable in the other).

Where a hybrid mismatch arises, the proposals would either deny a deduction for an otherwise deductible payment or tax a receipt that would be otherwise non-taxable. The response depends on the tax treatment in the other jurisdiction, which could change over time as more countries introduce hybrid mismatch rules. These changes are expected to be legislated by the second half of 2018.

Similar business test: A 'similar business test' is expected to be introduced to test when income tax losses and bad debts incurred in income years starting after 1 July 2015 can be used. Businesses that have changed ownership and fail the continuity of ownership test can now access prior-year tax losses or bad debt write-offs by meeting either the 'same-business test' or the new 'similar business test'.

Collective investment vehicle: Proposed measures would introduce a corporate collective investment vehicle (CIV) to create a potential alternative for some Australian investments outside of traditional trust structures. Trusts are often not well understood by non-residents, and this new regime could simplify some inbound Australian investment structures. These measures are the first stage of a new CIV regime that will be extended to limited partnerships in 2018.

Transparency of business tax debts: The government has released exposure draft legislation that will authorize the ATO to disclose business tax debts to credit reporting bureaus where the businesses have not effectively engaged with the ATO to manage their debt. This is a component of a growing focus on tax transparency which places increased focus on tax compliance management.

Asia Region Funds Passport: The Asia Region Funds Passport is a common framework of coordinated regulatory oversight to facilitate cross-border offerings of managed investment funds. Australia, Japan, Korea, New Zealand and Thailand signed the Passport's memorandum of cooperation, which took effect on 30 June 2016. Australia is progressing draft legislation to facilitate its implementation in 2018.

Asset purchase or share purchase

A foreign entity that is considering acquiring an existing Australian business needs to decide whether to acquire shares in an Australian company or its assets. Many small and medium-sized businesses in Australia are not operated by companies. Trusts are also common, and, in these cases, the only choice usually available is the acquisition of business assets. For larger businesses, a company is by far the most common structure. The commentary in this report focuses mostly on companies, although much of it applies equally to other business structures.

Within Australian corporate groups, the distinction between share and asset transactions is largely irrelevant for income tax purposes due to the operation of the tax consolidation rules. Generally, these rules treat a sale of shares as if it were a sale of assets. The buyer is then effectively able to push the purchase price of the target down to the underlying assets. The distinction is more important when dealing with other taxes, such as stamp duty and GST.

Hence, the decision to acquire assets or shares is normally a commercial one, taking into account the ease of executing the transaction and the history of the target.

Purchase of assets

Asset acquisitions often constitute a permanent establishment (PE) in Australia, with the assets forming all or part of the business property of the PE. Accordingly, the disposal of the assets is likely subject to CGT, whereas the disposal of shares by a non-resident is not ordinarily subject to CGT.

Purchase price

The total consideration must be apportioned between the assets acquired for tax purposes. It is common practice for the sale and purchase agreement to include an allocation in a schedule, which should be respected for tax purposes provided it is commercially justifiable. There may be a tension in this allocation between assets providing a useful cost base for income tax purposes and the stamp duty payable on the acquisition.

Although there are no specific income tax rules for allocating the purchase price among the various assets purchased, the market value consideration provisions in the CGT rules in effect arguably permit the ATO to determine an arm's length transfer price different from that allocated to the asset by the parties.

Additionally, earn-out purchase price mechanisms are commonly used in asset deals where the value of the business asset is uncertain. Broadly, under these mechanisms,

as proceeds for the sale of a target's business assets, the seller receives a lump sum payment plus a right to future payments that are contingent on the performance of the business (i.e. earn-out right). See 'Recent developments' for discussion of recently enacted changes affecting earn-out rights.

Goodwill

Goodwill paid for a business as a going concern generally cannot be deducted or amortized.

Therefore, the buyer may wish to have the purchase and sale agreement allocate all or most of the purchase price to the tangible assets to be acquired, thus reducing or eliminating any element of the purchase price assigned to goodwill. However, the lower price paid for goodwill also represents its cost base for CGT purposes, so this may increase the CGT exposure of the buyer in any subsequent sale. The impact on stamp duty liabilities should also be considered.

Depreciation

Most tangible assets may be depreciated for tax purposes, provided they are used, or installed ready for use, to produce assessable income. Rates of depreciation vary depending on the effective life of the asset concerned.

Capital expenditure incurred in the construction, extension or alteration of a building that is to be used to produce income may be depreciated for tax purposes using the straight-line method, normally at the rate of 2.5 percent per year. Entitlement to this capital allowance deduction usually accrues to the building's current owner or, in certain cases, a lessee or quasi-ownership right holder, even though the they may not be the taxpayer that incurred the construction costs. The entitled party continues to write off the unexpired balance of the construction cost.

An important consideration in any acquisition of Australian assets or shares in an Australian company that joins a pre-existing tax consolidated group is that, as part of the pushdown of the purchase price, depreciable assets can have their tax cost base reset to a maximum of their market value. In this scenario, any buildings acquired do not have their amortizable cost base increased, even though the tax cost base of the asset may be reset to a higher value. Capital allowances for expenditure on these assets are generally capped at 2.5 percent per year of the original construction cost, regardless of the market value of the asset. The reset tax cost base of these assets is only relevant on a future disposal of the asset.

On the disposal of depreciable plant and equipment, the excess of the market value over the tax written-down value for each item is included in the seller's assessable income. Conversely, where the purchase price is less than the tax written-down value, the difference is an allowable deduction to the seller.

Relatively few payments giving rise to intangible assets may be amortized or deducted for tax purposes. Currently, the main types of intangible assets that may be deducted or amortized are:

— software, including software used internally in the business

— cost of developing or purchasing patents, copyrights or designs, which are amortized over their effective life

— research and development (R&D) expenses incurred by eligible companies or partnerships of such companies

— capital expenditure, which can be deducted over a 5-year period, provided the expenditure is not otherwise taken into account (by being deducted under another provision of the tax law or capitalized into the tax cost base of an asset), the deduction is not denied under another provision, and the business is carried on for a taxable purpose.

In this context, a 'taxable purpose' broadly means for the purpose of producing assessable income in Australia. For example, expenditure incurred in setting up a new foreign subsidiary that will produce dividend income that is exempt from Australian tax would not be considered as related to carrying on a business for a taxable purpose.

The R&D tax incentive allows a 40 percent R&D tax offset for companies with turnover of AUD20 million or more. A 45 percent refundable tax offset applies for smaller companies/groups.

Tax attributes

Tax losses and franking (imputation credits) are not transferred as a result of an asset acquisition. The cost of depreciable assets is generally allocated as discussed earlier. However, a number of other matters must be considered:

— *Trading stock*: The disposal of the total trading stock is not a sale in the ordinary course of the seller's trading. Thus, the seller is required to bring into account the market value of that stock as income on the date of disposal. The buyer is deemed to have purchased the trading stock at that value. In practice, the ATO generally accepts the price paid as the market value of the stock where the seller and buyer are dealing at arm's length or the transaction occurs as part of a corporate group reorganization.

— *Debt*: Debts should not normally be acquired when the assets of a business are acquired. A deduction for bad debts is not generally available to the buyer since the amount claimed has never been brought to account as assessable income of the claimant/acquirer.

— *Prepayments*: When a business is acquired, it is preferable that any prepayments remain with the seller, as they may not be deductible by the buyer.

— *Employee leave provisions*: Australian income tax law denies the deduction of employee leave provisions

(e.g. holiday pay, long service leave). In most cases, a deduction becomes available only on payment to the employee, although there are limited exceptions relating to certain employment awards where the transfer of the provision may be deductible/ assessable.

— *Work-in-progress*: The profit arising from the sale of work-in-progress is assessable income to the seller. The buyer is fully assessable on the subsequent realization of that work-in-progress but obtains a tax deduction for the cost of acquiring the work-in-progress.

Foreign resident capital gains withholding tax

A buyer that acquires certain Australian assets from a seller that is a relevant foreign resident may pay up to 12.5 percent of the purchase price to the Commissioner of Taxation. The buyer must withhold this amount from the purchase price paid to the seller. This is a non-final withholding tax and is available as a refundable tax offset to the seller.

The obligation applies to the acquisition of an asset that is:

— a direct interest in taxable Australian real property (TARP)

— an indirect Australian real property interest (i.e. shares or units), or

— an option or right to acquire such property or such an interest.

Certain transactions are exempt from the withholding obligations, including transactions involving TARP (and certain indirect Australian real property interests) valued at less than AUD750,000 and transactions conducted through an approved stock exchange.

Further, no obligation is imposed where the seller obtains a clearance certificate from the Commissioner of Taxation or for indirect interests only where the seller has made a declaration about their residency status or the nature of the interest in their asset. The amount withheld may be varied, including to nil, where the seller makes appropriate applications to the Commissioner by the seller.

Foreign resident capital gains withholding tax applies in relation to acquisitions on or after 1 July 2016.

Value added tax

Goods and services tax, the Australian equivalent of valued added tax (VAT), applies to 'taxable supplies' (both goods and services), currently at a rate of 10 percent.

Disposals of assets have varying GST implications, depending on the nature of the transaction. If the sale of assets does not fall within the GST-free going concern exemption, the GST implications arising on the disposal of each asset need to be determined. A sale of assets is likely to be taxable, depending on the assets' nature.

For example, the disposal of trading stock, goodwill and intellectual property is normally treated as a taxable supply.

A transfer of debtors is an input taxed (i.e. exempt) supply, and the GST treatment on the transfer of real property depends on the nature of the property. Commercial property is generally a taxable supply (but may be GST-free subject to meeting certain criteria), while residential property depends on whether it is 'new' (taxable) or second-hand (input taxed). Farmland is taxable but may be GST-free, subject to satisfying certain criteria.

The availability of input tax credits (GST credits) to the buyer of a taxable supply of assets depends on how the buyer intends or actually uses those assets. Generally, full credits are available where the buyer intends to use the assets to make taxable or GST-free supplies. However, such credits may not be available where the assets are to be used to make input-taxed supplies (e.g. financial supplies or residential leasing supplies). Where full credits are not available, reduced credits (equivalent to 75 or 55 percent) may be available subject to certain criteria.

Transfer taxes

The stamp duty implications of a transfer of assets depend on the nature and location (by Australian state and territory) of the assets transferred. Stamp duty is imposed by each state and territory of Australia on the transfer of certain assets. Each jurisdiction has its own revenue authority and stamp duty legislation. Exemptions, concessions and stamp duty rates differ substantially among the Australian states and territories.

The assets to which stamp duty may apply in a typical acquisition of an Australian business include land and buildings (including leasehold land and improvements), chattels, debts, statutory licenses, goodwill and intellectual property. The specific types of assets subject to duty differ among the jurisdictions.

All states and territories, except Queensland, Western Australia and the Northern Territory, have abolished stamp duty on the transfer of non-real business assets, such as goodwill and intellectual property.

The maximum rates of duty range from 4.5 to 5.95 percent on the greater of the GST-inclusive consideration and the gross market value of the dutiable property. Additional foreign buyer surcharge duty applies for acquisitions of residential land in some jurisdictions. The buyer generally is liable to pay this duty.

Stamp duty can make reorganizations expensive. For this reason, it is often important to establish the optimum structuring of asset ownership at the outset to avoid further payments of duty on subsequent transfers.

However, most jurisdictions provide relief from duty for certain reconstructions within at least 90 percent-owned corporate groups. Such relief is subject to a number of conditions that vary among the jurisdictions, including certain pre-transaction and post-transaction association requirements for group members.

The exemption is not automatic. A formal application is required to be lodged with the relevant revenue authorities.

Purchase of shares

Non-residents are not subject to CGT on the disposal of shares in Australian companies unless the company is considered to have predominantly invested in real property.

This exemption does not protect non-resident investors who hold their investments in Australian shares on revenue account. Broadly, the acquisition of shares with the primary intention of future re-sale, whether by trade sale or initial public offering (IPO), could be characterized as a revenue transaction, even though the sale would occur several years in the future. In this respect, the ATO has made determinations that affect Australian investments by resident and non-resident private equity funds.

Australia's tax treaties usually apply so that non-residents disposing of shares on revenue account are not subject to Australian tax if they do not have a PE in Australia. However, this can be overridden by Australia's general anti-avoidance rule (GAAR; also known as 'Part IVA').

As noted earlier in this report, a 12.5 percent, non-final WHT applies to disposals by non-residents of certain Australian real property interests, which includes indirect real property interests.

Tax indemnities and warranties

In the case of negotiated acquisitions, it is usual practice in Australia for the buyer to request and the seller to provide indemnities or warranties as to any undisclosed taxation liabilities of the company to be acquired. The extent of the indemnities or warranties is a matter for negotiation.

Tax losses

Where the target company is a standalone company or the head company of an Australian tax consolidated group, carried forward tax losses may transfer along with the company, subject to transfer and utilization rules.

Where an Australian target company has carried forward tax losses, these generally continue to be available for recoupment only if there is greater than 50 percent continuity (with respect to dividends, capital and voting rights) in the beneficial ownership of the company. If this primary test is failed, as is usually the case in a takeover, the pre-acquisition losses are available for recoupment only if the Australian company, at all times during the year of recoupment, carries on the same business as it did immediately before the change in beneficial ownership of its shares.

This test is difficult to pass because it requires more than mere similarity in the businesses carried on. Its effect is that no new types of businesses or transactions may be entered into without the likely forfeiture of the losses, particularly in the case of an income tax consolidated group. As noted earlier in this report, the Australian government has proposed a second test in addition to the same business test. For losses incurred after 1 July 2015, the current same business test is expected to be relaxed to allow businesses to access past year losses where it has been conducting a 'similar' business at the relevant test times.

However, provided the transfer tests are satisfied, same business losses may be refreshed on acquisition by an income tax consolidated group. Given the potential uncertainty in this area, often a ruling is obtained from the tax authorities and/or detailed written tax advice is sought to confirm that the same-business test has historically been satisfied.

Similarly, no deduction for bad debts is available to the Australian company after its acquisition by the foreign entity unless there is either:

— more than 50 percent continuity of ownership in relation to the year the deduction is claimed and the year the debt was incurred, or

— continuity of the same business at relevant times.

When the target company becomes a member of the buyer's income tax consolidated group as a result of the transaction, the tax attributes of the company transfer the head company of the income tax consolidated group (i.e. tax losses, net capital losses, franking credits and foreign tax credits). Broadly, these losses may be transferable to the acquirer where the target has satisfied the modified same business test for the 12 months prior to the acquisition.

Limitation of loss rules restrict the rate at which such losses can be deducted against the taxable income of the consolidated group, based on the market value of the loss-making company as a proportion of the market value of the consolidated group as a whole. This is often a complex area.

By contrast, where the target company is a subsidiary member of an Australian income tax consolidated group, the tax attributes of the company leaving the group are retained by the head company of the group and do not pass to the buyer with the entity transferred.

Crystallization of tax charges

Under the self-assessment tax regime, the ATO generally is subject to a limited review period of 4 years following the lodgment of the income tax return or business activity statement (except in the case of tax evasion or fraud).

Pre-sale dividend

To prevent pre-sale dividends from being distributed to reduce capital gains arising on sale of shares, the ATO has ruled that a pre-sale dividend paid by a target company to the seller shareholder is part of the seller shareholder's capital proceeds for the share disposal (thereby increasing capital gain or reducing capital loss arising on the share sale), if the seller

shareholder has bargained for the dividend in return for selling the shares.

This follows the High Court of Australia decision in *Dick Smith*. In this case, the share acquisition agreement stipulated that a dividend would be declared on shares prior to transfer and the buyer was to fund the dividend (with the purchase price calculated by deducting the dividend amount). The court found the value of the dividend formed part of the consideration for the dutiable transaction for stamp duty purposes.

Complex anti-avoidance provisions also apply in this area.

GST

GST (VAT) does not apply to the sale of shares. The supply of shares is a 'financial supply' and input taxed if sold by a seller in Australia to a buyer in Australia. However, if the shares are sold to, or bought from, a non-resident that is not present in Australia, the sale may be a GST-free supply (i.e. zero rated).

While GST should not apply in either event, the distinction between an input taxed supply and a GST-free supply is important from an input tax credit-recovery perspective. Generally, full credits are not available for GST incurred on costs associated with making input taxed supplies, but full credits should be available for GST-free supplies.

Stamp duty

All states and territories impose landholder duty on 'relevant acquisitions' of interests in companies or unit trusts that are 'landholders'. The tests for whether an entity is a landholder differ among the jurisdictions. In some jurisdictions, landholder duty is also imposed on certain takeovers of listed landholders.

Landholder duty is imposed at rates of up to 5.95 percent of the value of the land (land and goods in some states) held by the landholder. A concessional rate of duty applies to takeovers of listed landholders in some states (the concessional rate is 10 percent of the duty otherwise payable). Additional foreign buyer surcharge duty applies on acquisitions of interests in companies or unit trusts which directly or indirectly hold residential land.

The acquirer generally is liable to pay stamp duty, but in some jurisdictions the landholder and acquirer are jointly and severally liable for stamp duty.

Tax clearances

It is not possible to obtain a clearance from the ATO giving assurances that a potential target company has no arrears of tax or advising as to whether or not it is involved in a tax dispute.

Where the target company is a member of an existing income tax consolidated group or GST group, the buyer should ensure the target company is no longer liable for any outstanding tax liabilities of the existing group (e.g. if the head company of that group defaults). The buyer should ensure that the target company:

— is party to a valid tax-sharing agreement and indirect tax-sharing agreement with the head company and other members of the existing group, which reasonably limits the target company's exposure to its own standalone tax liabilities

— exits the existing group with no outstanding group liabilities by attaining evidence that the existing company made an exit payment to the head company of the group.

The ATO has a detailed law administration practice statement that sets out its approach to recovering outstanding group tax liabilities from an exiting company. The buyer should bear this in mind when assessing the tax position of the target company.

Choice of acquisition vehicle

After the choice between the purchase of shares or assets has been made, the second decision concerns the vehicle to be used to make the acquisition and, as a consequence, the position of the Australian operations in the overall group structure. The following vehicles may be used to acquire the shares or assets of the target:

— foreign company

— Australian branch of the foreign company

— special-purpose foreign subsidiary

— treaty country intermediary

— Australian holding company

— joint venture

— other special purpose vehicle (e.g. partnership, trust or unit trust).

The structural issues in selecting the acquisition vehicle can usually be divided into two categories:

— the choice between a branch or a subsidiary structure for the acquired Australian operations

— whether there would be advantages to interposing an intermediary company as the head office for the branch or the holding company for the subsidiary.

Local holding company

It is common to interpose an Australian holding company between a foreign company (or third-country subsidiary) and an Australian subsidiary. The Australian holding company may act as a dividend pool because it can receive dividends free of further Australian tax and re-invest these funds in other group-wide operations. It is common to have an Australian holding company act as the head entity of an income tax consolidated group.

Foreign parent company

Where the foreign country of the parent does not tax capital gains, the foreign parent may wish to make the investment directly. Non-residents are not subject to CGT on the disposal of shares in Australian companies unless the company is considered to have predominantly invested in real property (as discussed earlier). However, while Australian withholding tax (WHT) on interest is generally 10 percent for treaty and non-treaty countries, the WHT on dividends is commonly limited to 15 percent on profits that have not been previously taxed (referred to as 'unfranked' or 'partly franked' dividends; see 'Dividend imputation rules' below), but only when remitted to treaty countries. (Australia's more recent treaties may reduce this rate further if certain conditions are satisfied).

The dividend WHT rate is 30 percent for unfranked dividends paid to non-treaty countries. The tax on royalties paid from Australia is commonly limited to 10 percent for treaty countries (30 percent for non-treaty countries). Therefore, an intermediate holding company in a treaty jurisdiction with lower WHT rates may be preferred, particularly if the foreign parent is unable to fully use the WHT as a foreign tax credit in its home jurisdiction (subject to limitation on benefit clauses in tax treaties and the application of the Australian GAAR).

Non-resident intermediate holding company

If the foreign country imposes tax on capital gains, locating the subsidiary in a third country may be preferable. The third-country subsidiary may also sometimes achieve a WHT advantage if the foreign country does not have a tax treaty with Australia.

However, some treaties contain anti-treaty shopping rules. As noted, the ATO has ruled in a taxation determination that the Australian domestic GAAR would apply to inward investment private equity structures designed with the dominant purpose of accessing treaty benefits. The taxation determination demonstrates the ATO's enhanced focus on whether investment structures (e.g. the interposition of holding companies in particular countries) have true commercial substance and were not designed primarily for tax benefits.

A key consideration in this regard is to ensure the payee beneficially owns the dividends or royalties. Beneficial entitlement is a requirement in most of Australia's treaties.

Australia has signed the multilateral instrument (MLI) and will adopt the principal purpose test (PPT) within its tax treaties where the treaty partner jurisdiction has also elected to adopt the PPT.

Local branch

Forming a branch may not seem to be an option where shares rather than assets are acquired. This is because, in effect, the foreign entity has 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. Great care needs to be taken when creating a branch from a subsidiary in this way, including consideration of the availability of CGT rollover relief, potential stamp duties and the presence of tax losses.

However, a branch is not usually the preferred structure for the Australian operations. Many of the usual advantages of a branch do not exist in Australia:

— There are no capital taxes on introducing new capital either to a branch or to a subsidiary.

— No WHT applies on taxed branch profits remitted to the head office or on dividends paid out of taxed profits (i.e. franked dividends'; see 'Dividend imputation rules' below) from an Australian subsidiary.

— The profits of an Australian branch of a non-resident company are taxed on a normal assessment basis at the same rate as the profits of a resident company.

The branch structure has one main potential advantage. Where the Australian operations are likely to incur losses, in some countries, these may be offset against domestic profits. However, the foreign acquirer should consider that deductions for 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 much more doubtful than the equivalents for subsidiaries, except where it can be shown that the payments are effectively being made to third parties.

The only provisions that might restrict the deduction for a subsidiary are the arm's length pricing rules applicable to international transactions and the thin capitalization provisions.

Reorganizations and expansions in Australia are usually simpler where an Australian subsidiary is already present.

An Australian subsidiary would probably have a much better local image and profile and gain better access to local finance than a branch. The repatriation of profits may be more flexible for a subsidiary, as it may be achieved either by dividends or by eventual capital gain on sale or liquidation. This can be especially useful where the foreign country tax rate is greater than 30 percent; in such cases, the Australian subsidiary may be able to act as a dividend trap. Finally, although Australian CGT on the sale of the subsidiary's shares might be avoided, this is not possible on the sale of assets by a branch, which is, by definition, a PE.

Two other frequently mentioned advantages of subsidiaries are limited liability (i.e. inaccessibility of the foreign company's funds to the Australian subsidiary's creditors) and possible requirements for less disclosure of foreign operations than in the branch structure. However, both these advantages can also be achieved in Australia through the use of a branch, by

interposing a special-purpose subsidiary in the foreign country as the head office of the branch.

Joint venture

Where the acquisition is to be made together with another party, the parties must determine the most appropriate vehicle for this joint venture. In most cases, a limited liability company is preferred, as it offers the advantages of incorporation (separate legal identity from that of its members) and limited liability (lack of recourse by creditors of the Australian operations to the other resources of the foreign company and the other party). Where the foreign company has, or proposes to have, other Australian operations, its shareholding in the joint venture company is usually held by a separate wholly owned Australian subsidiary, which can be consolidated with the other operations.

It is common for large Australian development projects to be operated as joint ventures, especially in the mining industry. Where the foreign company proposes to make an acquisition in this area, it usually must decide whether to acquire an interest in the joint venture (assets) or one of the shares of the joint ventures (usually, a special-purpose subsidiary). This decision and decisions relating to the structuring of the acquisition can usually be made in accordance with the preceding analysis.

Trusts

Trusts, particularly Australian unit trusts, are popular investment structures in Australia. Under a trust arrangement, the legal owner (the trustee) holds the property 'in trust' for the benefit of the beneficial owners (the unit holders). In essence, the trust separates the legal and beneficial ownership of the property.

Depending on the objectives for entering into the arrangement, trusts can be established in a number of different forms, including discretionary trusts and unit trusts.

In a discretionary trust (or family trust), the beneficiaries do not have a fixed entitlement or interest in the trust funds. The trustee has the discretion to determine which of the beneficiaries are to receive the capital and income of the trust and how much each beneficiary is to receive. The trustee does not have a complete discretion. The trustee can only distribute to beneficiaries within a nominated class as set out in the terms of the trust deed.

A unit trust is a trust in which the trust property is divided into a number of defined shares, or 'units'. The beneficiaries subscribe for the units in much the same way as shareholders in a company subscribe for shares. Some benefits on the use of a unit trust over a discretionary trust and company include:

- clearly defined interest in the asset and income of the trust
- less regulation than a company
- trust deed can be tailored to the needs of the beneficiaries
- no legal issues on the redemption of units by the unit holders
- easier to wind-up than a company.

To the extent an Australian trust's income is sourced in Australia, corresponding distributions to non-resident unit holders are generally subject to WHT. The rate of tax and method of payment depends on whether the income represents:

- *Interest*: The trust is generally required to withhold tax at 10 percent, which is a final tax.
- *Distributions*: On distributions made by a flow-through unit trust, the trust is generally required to withhold tax at 30 percent depending on the recipient entity type.
- *Foreign superannuation funds*: These funds are exempt from income tax in their own country and are not subject to Australian interest or dividend WHT.
- *MITs*: The MIT regime is a concessional WHT regime that is used primarily in Australian real estate investment. The regime's key benefit is that the rate of WHT on distributions of net rental income and capital gains made by the MIT may be as low as 15 percent (or 10 percent for a 'clean' building) when distributed to residents of 'exchange of information countries' per the Australian tax regulations. An MIT is a unit trust that satisfies certain requirements:
  - The trust must satisfy a widely held ownership requirement and must not be closely held under the applicable tests.
  - A 'substantial proportion' of the 'investment management activities' must be carried out in Australia.
  - The trust must not be carrying on a 'trading business' or control another entity that is carrying on a 'trading business'.

Certain managed investment trusts are able to elect into the attribution MITs (AMIT) regime. The AMIT regime:

- allows AMITs to use a simplified attribution method of tax in relation to distribution of income
- allows AMITs to carry forward under- and over-estimates of tax amounts into the discovery income year, generally without adverse tax consequences
- allows unit holders in AMITs to make both upward and downward adjustments to the cost base of their unit holdings in certain circumstances to eliminate double taxation that may otherwise arise
- deems AMITs that meet eligibility requirements to be fixed trusts, which can have benefits for tax loss testing and CGT treatment

— does not give a trust access to the concessional WHT regime but does not preclude access either, that is, a trust can simultaneously be both an AMIT and a withholding MIT.

The AMIT rules have effect from 1 July 2016, with the option of early adoption from 1 July 2015.

Choice of acquisition funding

Where a buyer uses an Australian holding company in an acquisition, the form of this investment must be considered. Funding may be by way of debt or equity. A buyer should be aware that Australia has a codified regime for determining the debt or equity classification of an instrument for tax purposes. This is, broadly, determined on a substance over form basis.

In the context of equity funding, it will also need to be considered whether the issue of shares or units in a landholder may trigger landholder duty (see 'Stamp duty' above).

Debt

Generally, interest is deductible for income tax purposes (subject to commentary below), but dividends are not. Additionally, the non-interest costs incurred in borrowing money for business purposes, such as the costs of underwriting, brokering, legal fees and procurement fees, may be generally written-off and deducted over the lesser of 5 years or the term of the borrowing.

Whether an instrument is debt or equity for tax purposes is a key consideration in implementing a hybrid financing structure, discussed later.

Deductibility of interest

Interest payable on debt financing is generally deductible in Australia, provided the borrowed funds are used in the assessable income-producing activities of the borrower or to fund the capitalization of foreign subsidiaries. No distinction is made between funds used as working capital and funds used to purchase capital assets.

The major exceptions to this general rule are as follows:

— Where the thin capitalization rules are breached, a portion of the interest is not deductible.

— In addition to the quantum of the loan being arm's length under the thin capitalization rules (or within the safe harbor limits), the interest rate on loans must be arm's length in accordance with transfer pricing principles.

— Interest expenses incurred in the production of certain tax-exempt income are not deductible.

— Interest expenses incurred in the holding of a capital asset are not deductible where the only prospective assessable income in Australia is the capital gain potentially available on sale (the interest expenses may be included in the cost base for CGT purposes).

The thin capitalization rules apply to inbound investing entities with respect to all debt that gives rise to tax deductions. These rules deny interest deductions where the average amount of debt of a company exceeds the safe harbor debt amount, the alternative arm's length debt amount and, in certain circumstances, the worldwide debt amount of the company.

The safe harbor debt amount is essentially 60 percent of the value of the assets of the Australian company, which is a debt-to-equity ratio of 1.5:1. For financial institutions, this ratio is increased to 16:1. The arm's length debt amount is the amount of debt that the Australian company could reasonably be expected to have borrowed from a commercial lending institution dealing at arm's length.

The thin capitalization rules, subject to additional safe harbors, apply to Australian groups operating overseas (outbound investing entities) in addition to Australian entities that are foreign-controlled and Australian operations of foreign multinationals.

As the thin capitalization rules apply regarding all debt that gives rise to tax deductions, no distinction is made between connected and third-party financing or between local and foreign financing.

Withholding tax on debt

Australia generally imposes WHT at 10 percent on all payments of interest, including amounts in the nature of interest (e.g. deemed interest under hire purchase agreements or discounts on bills of exchange). The 10 percent rate applies to countries whether or not Australia has concluded a tax treaty with the country in question. However, the applicable interest WHT rate may be reduced to 0 percent on certain interest payments to financial institutions by some of Australia's more recent tax treaties (including those with the US, UK, France and Japan). Few techniques to eliminate WHT on interest are available.

Interest paid on widely held debentures issued outside Australia for the purpose of raising a loan outside Australia is exempt from WHT where the interest is paid outside Australia. As Australian WHT cannot usually be avoided, the acquisition should be planned to ensure that credit is available in the country of receipt.

Australia does not impose WHT on franked dividends. Australia imposes WHT on the unfranked part of a dividend at a rate that varies from 15 percent, the usual rate in Australia's treaties, to 30 percent for all non-treaty countries. In the case of the US and UK treaties, the rate of dividend withholding may be as low as 0 percent.

Australia is renegotiating its tax agreements with its preferred trading partners with a view to extending the 0 percent concessional WHT rate.

Checklist for debt funding

— Interest WHT at 10 percent ordinarily applies to cross-border interest, except to banks in the UK and US,

unless the interest is paid in relation to a publicly offered debenture.

— Third-party and related-party debt are treated in the same manner for Australian thin capitalization purposes.

— Interest expense in a financing vehicle can be offset against income of the underlying Australian business when it is part of an Australian tax consolidated group.

Equity

Scrip-for-scrip relief

Equity is another alternative for funding an acquisition. This may take the form of a scrip-for-scrip exchange whereby the seller may be able to defer any gain, although detailed conditions must be satisfied.

The main conditions for rollover relief include:

— All selling shareholders can participate in the scrip-for-scrip exchange on substantially the same terms.

— Under the arrangement, the acquiring entity must become the owner of 80 percent or more of the voting shares in the target company, or the arrangement must be a takeover bid or a scheme of arrangement approved under the Corporations Act 2001.

— The selling shareholders hold their shares in the target company on capital account (i.e. the shares are not trading stock).

— The selling shareholders acquired their original shares in the target company on or after 20 September 1985.

— Apart from the rollover, the selling shareholders would have a capital gain on the disposal of their shares in the target company as a result of the exchange.

Additional conditions apply where both the target company and the buyer are not widely held companies or where the selling shareholder, target company and buyer are commonly controlled.

Where the selling shareholders receive only shares from the acquiring company (the replacement shares) in exchange for the shares in the target company (the original shares) and elect for scrip-for-scrip rollover relief, they are not assessed on any capital gain on the disposal of their original shares at the time of the acquisition. Any capital gain on the shares is taxed when they dispose of their replacement shares in the acquiring company. Where the sellers receive both shares and other consideration (e.g. cash), only partial CGT rollover is available. The cost base of the original shares is apportioned on a reasonable basis between the replacement shares and the other consideration, and the selling shareholders are subject to CGT at the time of the share exchange to the extent that the value of the other consideration received exceeds the allocated portion of the original cost base of the original shares.

Where the selling shareholders acquired their original shares prior to 20 September 1985 (pre-CGT shareholders), subject to transitional provisions, the selling shareholders are not subject to CGT on the disposal of the original shares, so they do not require rollover relief. However, such shareholders lose their pre-CGT status, so they are subject to CGT on any increase in the value of the replacement shares between the acquisition and subsequent disposal of the replacement shares. The cost base of the replacement shares that a pre-CGT shareholder receives is the market value of those shares at the time of issue.

Provided the target company or buyer is a widely held company, the cost base of the shares in the target company that are acquired by the buyer is the market value of the target company at the date of acquisition. The CGT cost base of the target shares acquired by the buyer is limited if the selling shareholders' cost base in the target company (i.e. no step-up to market value is available) if:

— the shares are acquired from a substantial shareholder who holds a 30 percent or more interest (together with associates) in the target company

— the shares are acquired from common shareholders in the target company and the buyer company, who, together with associates, hold an 80 percent or more interest in the target company prior to the acquisition and an 80 percent or more interest in the buyer after the acquisition, or

— the shares are acquired as part of a 'restructure' under the scrip-for-scrip arrangement rather than a genuine takeover.

Generally, a company is widely held if it has at least 300 members. Special rules prevent a company from being treated as widely held if interests are concentrated in the hands of 20 or fewer individuals.

Demerger relief

Demerger relief rules are also available to companies and trusts where the underlying ownership (at least 80 percent) of the divested membership interests in a company is maintained on a totally proportionate basis. These rules are not available to membership interests held on revenue account. In an M&A context, safeguards in the anti-avoidance provisions prevent demergers from occurring where transactions have been pre-arranged to effect change in control.

The demerger relief available is as follows:

— CGT relief at the shareholder level providing for cost base adjustments between the original and new membership interests

— CGT relief at the corporate level providing for a broad CGT exemption for the transfer or cancellation of membership interests in the demerged entity

— deeming the divestment of shares to shareholders not to be a dividend, subject to anti-avoidance rules.

Dividend imputation rules

Australia operates an imputation system of company taxation through which shareholders of a company gain relief against their own tax liability for taxes paid by the company.

Resident companies must maintain a record of the amount of their franking credits and franking debits to enable them to ascertain the franking account balance at any point in time, particularly when paying dividends. This franking account is a notional account maintained for tax purposes and reflects the amount of company profits that may be distributed as franked dividends.

Detailed rules determine the extent to which a dividend should be regarded as franked. A dividend may be partly franked and partly unfranked. Generally, a dividend is franked where the distributing company has sufficient taxed profits from which to make the dividend payment and the dividend is not sourced from the company's share capital.

Dividends paid to Australian resident shareholders carry an imputation rebate that may reduce the taxes payable on other income received by the shareholder. Additionally, shareholders who are Australian resident individuals and complying superannuation funds can obtain a refund of excess franking credits.

For non-resident shareholders, however, franked dividends do not result in a rebate or credit but instead are free of dividend WHT (to the extent to which the dividend is franked).

No dividend WHT is levied on dividends paid by a resident company to its resident shareholders. Income tax assessed to an Australian-resident company generally results in a credit to that company's franking account equivalent to the amount of taxable income less tax paid thereon.

The franking account balance is not affected by changes in the ownership of the Australian company. As non-resident companies do not obtain franking credits for tax paid, an Australian branch has no franking account or capacity to frank amounts remitted to a head office.

Hybrids

Due to Australia's thin capitalization regime, a buyer usually finances through a mix of debt and equity and may consider certain hybrid instruments. Australia does not impose stamp duty on the issue of new shares in any state, and there is no capital duty. However, it should be considered whether landholder duty may be triggered on the issue of shares in a landholder.

As noted earlier in this report, the characterization of hybrids (e.g. convertible instruments, preferred equity instruments and other structured securities) as either debt or equity is governed by detailed legislative provisions that have the overriding purpose of aligning tax outcomes to the economic substance of the arrangement.

These provisions contain complex, interrelated tests that, in practice, enable these instruments to be structured such that subtle differences in terms can decisively alter the tax characterization in some cases. Examples of terms that can affect the categorization of an instrument include the term of the instrument, the net present value of the future obligations under the instrument and the degree of contingency/certainty surrounding those obligations.

Additionally, the debt/equity characterization of hybrid instruments under the Australian taxation law and that under foreign taxation regimes have been subject to enhanced scrutiny by the ATO and foreign revenue authorities. In this context, consideration should be given to the application of the proposed hybrid mismatch tax regime and an integrity provision that deems an interest from an arrangement that funds a return through connected entities to be an equity interest under certain circumstances (and thus causes returns to be non-deductible).

The careful structuring of hybrid instruments is a common focus in Australian business finance. In some cases, this focus extends to cross-border hybrids, which are characterized differently in different jurisdictions. The proposed changes for hybrid mismatches discussed above may remove the previous benefits from the differences in classifications between jurisdictions.

Discounted securities

Historically, a complex specific statutory regime has applied that, broadly, seeks to tax discounted securities on an accruals basis. This treatment is essentially preserved under the Taxation of Financial Arrangements (TOFA) provisions, which aim to align the tax and accounting treatment of financial arrangements. Note that interest WHT at 10 percent may apply when such a security is transferred for more than its issue price.

Deferred settlement

Where settlement is deferred on an interest-free basis, any CGT liability accruing to the seller continues to be calculated from the original disposal date and on the entire sale proceeds. Furthermore, where interest is payable under the settlement arrangement, it does not form part of the cost base. Rather, it is assessable to the seller and deductible to the buyer to the extent that the assets or shares are capable

of producing assessable income, other than the prospective capital gain on resale. See 'Recent developments' for discussion of recent changes affecting earn-outs.

Concerns of the seller

Non-residents generally are exempt from CGT on the disposal of Australian assets held on capital account, including a disposal of shares in a company or interests in a trust. The key exception is where a non-resident has a direct or indirect interest in real property, which is defined broadly to include leasehold interests, fixtures on land and mining rights. The provisions that seek to apply CGT in these circumstances are extremely broad and carry an extraterritorial application in that non-residents disposing of interests in upstream entities that are not residents of Australia may also be subject to CGT. Similarly, stamp duty is potentially payable by a buyer in these circumstances.

The CGT exemption for non-residents does not apply to assets used by a non-resident in carrying on a trade or business wholly or partly at or through a PE in Australia.

The ATO has also historically argued that disposals by overseas private equity funds may have an Australian source and be taxable on revenue account and therefore not benefit from the exemption for non-residents on capital gains on Australian shares in such cases, the source of the gain will be critical in determining Australian taxing rights.

Where a purchase of assets is contemplated, the seller's main concern is likely to be the CGT liability arising on assets acquired after 19 September 1985. Where the sale is of a whole business or a business segment that was commenced prior to CGT, the seller normally seeks to allocate as much of the price as possible to goodwill. Payment for goodwill in these circumstances is generally free from Australian income tax, unless there has been a majority change in underlying ownership of the assets.

The CGT liability may also be minimized by favorably spreading the overall sale price of the assets in such a way that above-market prices are obtained for pre-CGT assets and below-market prices obtained for post-CGT assets. Such an allocation may be acceptable to the buyer because it may not substantially alter the CGT on sales.

However, the prices for all assets should be justifiable; otherwise, the ATO may attack the allocation as tax avoidance or non-arm's length. The buyer would also be keen to review the allocation, with particular reference to those assets that have the best prospects for future capital gains.

The seller is concerned about the ability to assess the amount of depreciation recouped where depreciable assets (other than buildings) are sold for more than their tax written-down value.

The excess of consideration over the tax written-down value is included in assessable income in the year of sale as a balancing adjustment and taxed according to the normal income tax rules. Where a depreciable building is sold, no such balancing adjustment is generally made. Where a depreciable asset (other than a building) is sold for less than its tax written-down value, the loss is deductible as a balancing deduction in the year of sale. This balancing deduction is not treated as a capital loss.

Strictly speaking, the seller is also required to include as assessable income the market value of any trading stock sold, even though a different sale price may be specified in the sale agreement. As noted earlier, the ATO's usual practice is to accept the price paid as the market value.

Stamp duty is payable by the buyer but inevitably affects the price received by the seller.

GST considerations are also relevant to the seller. As noted above, the sale of assets may be a taxable supply unless the sale qualifies as a GST-free supply of a going concern. Where the going concern exemption is not available, the types of assets being transferred need to be considered individually to determine the applicable GST treatment. While the sale and purchase of shares does not attract GST, full input tax credits may not be available for GST incurred on transaction costs associated with the sale or purchase. For some costs, a reduced input tax credit may be available for certain prescribed transaction costs.

Where the seller company has carried forward losses, the sale of business assets does not ordinarily jeopardize its entitlement to recoup those losses. However, the seller company may be relying on satisfaction of the same business test (see 'Tax losses' above) to recoup the losses (e.g. due to changes in the ownership of the seller since the year(s) of loss). Care is then required, as the sale of substantial business assets could jeopardize satisfaction of this test and lead to forfeiture of the losses.

Where a purchase of shares is contemplated, the seller may have several concerns, depending on the seller's situation. Potential concerns include the following:

— Current or carried forward losses remain with the company, so they are unavailable to the seller where the shares in the company are sold. If the seller currently has an entitlement to such losses without recourse to the same business test, this entitlement is not forfeited when the business assets are sold and the seller may be able to inject new, profitable business to recoup these losses. Similarly in a share sale scenario, where the target company is included within the seller's tax consolidated group prior to sale, the seller retains the tax losses.

— Where the seller acquired all or part of its shareholding after 19 September 1985, the sale of shares has CGT consequences and a capital gain or loss may accrue. Where the acquisition is achieved by way of a share swap, CGT rollover relief may be available. Where the target company forms part of the seller's tax consolidated

group, the seller is treated as if it had disposed of the assets of the target company; any gain is calculated as the excess of the sale proceeds over the tax cost base of the assets (less liabilities) of the target company. Where the liabilities of the target company exceed the tax cost base of the target's assets, a deemed capital gain arises for the seller.

— The buyer may request indemnities or warranties (usually subject to negotiation).

— Any gain on the sale of pre-CGT shares may also be assessable where the seller is dealing in shares or where the seller purchased the shares either with the intention of sale at a profit or as part of a profit-making endeavor.

— For shares in a private company or interest in a private trust acquired before 19 September 1985, where the value of the underlying assets of a company or trust acquired after 19 September 1985 represents 75 percent or more of the net worth of the company or trust, CGT may be payable.

Company law and accounting

Corporations Act 2001 and IFRS

The Australian Corporations Act 2001 (Corporations Act) governs the types of company that can be formed, ongoing financial reporting and external audit requirements, and the repatriation of earnings (either as dividends or returns of capital).

Australian accounting standards issued by the Australian Accounting Standards Board (AASBs) are effectively the equivalent of International Financial Reporting Standards (IFRS). The acquisition of a business, regardless of whether it is structured as a share acquisition or asset acquisition, is accounted for using purchase under business combination accounting in accordance with AASB 3 Business Combinations (AASB 3).

Under purchase business combination accounting, all identifiable assets and liabilities are recognized at their respective fair values on the date that control of the business is obtained. Identifiable assets may include intangible assets that are not recognized on the target's balance sheet. These intangible assets may have limited lives and require amortization.

In a business combination, liabilities assumed include contingent liabilities, which are also recognized on the balance sheet at their estimated fair value.

The difference between consideration paid (plus the balance of non-controlling interest at acquisition date and the acquisition date fair value of the acquirer's previous interest in the acquire) and the ownership interest in the fair value of acquired net assets represents goodwill. Goodwill is not amortized but is tested for impairment annually. Any negative goodwill impairment is recognized immediately in the income statement.

Transaction costs associated with business combinations occurring in fiscal years commencing on or after 1 July 2009 are expensed as incurred. Acquisition-related costs are generally expensed as incurred with the exception of costs relating to the costs of issuing debt or equity securities.

The reorganization of businesses under the control of the same parent entity is outside the scope of AASB 3 accounting standards. Typically, these such restructurings occur at book values, with no change in the carrying value of reported assets and liabilities and no new goodwill. Again, transaction costs associated with these common control transactions are generally expensed as incurred.

Reporting obligations

Generally, all substantial Australian companies have an obligation to file audited financial statements with the Australian Securities and Investments Commission (ASIC). ASIC monitors compliance with the Corporations Act. These financial statements are publicly available.

Filing relief may be available for certain registered foreign companies and Australian entities by taking advantage of class order relief granted by ASIC.

Payment of dividends

The payment of dividends by companies to their shareholders is governed by the Corporations Act and the relevant company's constitution in conjunction with the accounting standards and taxation law.

Under the Corporations Act, a company currently cannot pay a dividend to its shareholders unless its assets exceed its liabilities immediately before the dividend is declared and the excess is sufficient for the payment of the dividend. The dividend payment must also be fair and reasonable to shareholders as a whole and must not materially prejudice the company's ability to pay its creditors.

The above requirements replaced the former profits-based test, which provided that a company could only pay a dividend out of profits. Currently, however, it is ambiguous whether a dividend declared other than out of profits (e.g. by relying on the net assets test only) would constitute an unlawful reduction of capital (as the Corporations Act prescribes a procedure that must be followed to effect a capital reduction). As a result, companies need to ensure all legal requirements are met and avoid dividend traps (i.e. the inability to stream profits to the ultimate shareholder due to insufficient profits and assets within a chain of companies). Note that for income tax purposes, the ATO's view is that a dividend needs to be paid out of profits in order for a shareholder to obtain a credit for the tax paid by the company.

The assessment of whether the applicable requirements have been met (including in relation to available profits) for the declaration of a dividend is determined on a standalone, legal-entity-by-legal-entity basis, not the consolidated position of the corporate group. This entity-by-entity assessment requires planning to avoid dividend traps. Appropriate pre-acquisition structuring helps minimize this risk. Australian law does not have a concept of par value for shares. As mentioned above, the Corporations Act prescribes how share capital can be reduced, including restrictions on the redemption of redeemable preference shares.

Other considerations

Group relief/consolidation

Where the buyer owns other Australian companies and has elected to form an Australian income tax consolidated group, the target company becomes a subsidiary member on acquisition. Only wholly owned subsidiaries can join an Australian tax consolidated group.

Issues that arise as a result of the tax-consolidation regime for share acquisitions are as follows:

- A principle underlying the income tax consolidation regime is the alignment of the tax value of shares in a company with its assets. On acquisition, it may be possible to obtain a step-up in the tax value of assets of the newly acquired subsidiary when it joins a consolidated group by pushing down the purchase price of the shares to the underlying assets. The acquiring company is effectively treated as purchasing the assets of the target company, including any goodwill reflected as a premium in the share price above the value of the net assets of the company.
- Because the tax basis of a target's CGT assets is reset, the acquiring company can dispose of unwanted CGT assets acquired as part of the acquisition with no tax cost.
- Each corporate member of a tax consolidated group or GST group is jointly and severally liable for the tax and GST liabilities of the whole group. As noted above, this liability can be limited where the companies within the group enter into a tax-sharing agreement (or indirect tax-sharing agreement for GST purposes). When acquiring a company that formed part of an income tax- or GST-consolidated group, it is important to determine the extent of its exposure for the tax liabilities of its previous group and mechanisms to reduce this exposure.
  - Where an Australian entity is acquired directly by a foreign entity and the foreign entity has other Australian subsidiaries that have formed a tax-consolidated group, there is an irrevocable choice as to whether or not to include the newly acquired Australian entity in the tax consolidated group. Alternatively, where the Australian entity is acquired by an existing Australian entity that forms part of an income tax consolidated group, the newly acquired Australian entity is automatically included in the existing group. However, a newly acquired Australian entity is not automatically included in an existing GST-consolidated group.
  - The historical tax expense and cash flow of the target company is no longer a valid indicator for projecting future cash tax payments. The resetting of the tax base in the assets of the company makes tax modeling for the cash outflows more important.

Transfer pricing

Australia has a complex regime for the taxation of international related-party transactions. These provisions specify significant contemporaneous documentation and record-keeping requirements.

The transfer pricing rules focus on determining an arm's length profit allocation and provide the Commissioner of Taxation with broad powers of reconstruction in respect of international related-party dealings.

General anti-avoidance rule

The GAAR (Part IVA) can apply where:

- a taxpayer enters into a scheme
- the taxpayer obtains a tax benefit from the scheme
- the circumstances indicate that the obtaining of that tax benefit was a dominant purpose of one of the parties.

If the GAAR applies to a scheme, the Commissioner may cancel the tax benefit, make compensating adjustments and impose substantial penalties.

Dual residency

Dual residency is unlikely to give rise to any material Australian tax benefits and could significantly increase the complexity of any transaction.

Foreign investments of a local target company

Where an Australian target company holds foreign investments, the question arises as to whether those investments should continue to be held by the Australian target company or whether it would be advantageous for a sister or subsidiary company of the foreign acquirer to hold the foreign investments.

Australia has a comprehensive international tax regime that applies to income derived by controlled foreign companies (CFC). The objective of the regime is to place residents who undertake certain passive or related-party income earning activities offshore on the same tax footing as residents who invest domestically.

Under the current CFC regime, an Australian resident is taxed on certain categories of income derived by a CFC if the taxpayer has an interest in the CFC of 10 percent or more. A

CFC is broadly defined as a foreign company that is controlled by a group of not more than five Australian residents whose aggregate controlling interest in the CFC is not less than 50 percent. However, a company may also be a CFC in certain circumstances where this strict control test is not met but the foreign company effectively is controlled by five or fewer Australian residents.

Taxpayers subject to the current CFC regime must calculate their income by reference to their interest in the CFC. The income is then attributed to the residents holding the interest in the CFC in proportion to their interests in the company — that is, the Australian resident shareholders are subject to tax in Australia on their share of the attributable earnings of the CFC.

Any income of a CFC that has been subjected to foreign or Australian tax can offset that amount with a credit against Australian tax payable. Excess credits may be carried forward for up to 5 income years. The income of a CFC generally is not attributed where the company is predominantly involved in actively earning income.

Given the comprehensive nature of the CFC regime and the few exemptions available, the Australian target company may not be the most tax-efficient vehicle for holding international investments. However, due to a recent series of reforms relating to conduit relief, Australia is now a favorable intermediary holding jurisdiction. In particular, Australia now has broad participation exemption rules that enable dividend income sourced from offshore subsidiaries and capital profits on realization of those subsidiaries to be paid to non-resident shareholders free from domestic income tax or non-resident WHT.

Foreign investment into Australia

Australia has a foreign investment review framework that requires certain proposals by foreign persons to be approved by Australia's Foreign Investment Review Board (FIRB) before they are implemented. The package of legislative reforms that commenced on 1 December 2015 represents the most significant changes to Australia's foreign investment regime since it was introduced over 40 years ago. The primary objectives of the reforms are to provide stronger enforcement and a better-resourced system with clearer rules for foreign investors. Some of the key changes include stricter penalties for contravening the foreign investment framework, new fees on foreign investment applications and the ATO's enlistment in ensuring compliance and enforcement of critical aspects of the regime.

Determining whether an application for approval is required to be made to FIRB depends on a range of factors that must be carefully assessed case-by-case. These factors include the type of investor, the type of investment, the industry sector in which the investment will be made and the value of the investment.

To avoid delays, it is crucial for foreign investors to consider at an early stage of any transaction whether approval under Australia's foreign investment regime will be required.

Comparison of asset and share purchases

Advantages of asset purchases

— Step-up in the tax value of all assets (minor exceptions only).

— A deduction is available for trading stock purchased.

— No previous liabilities of the company are inherited.

— Possible to acquire only part of a business.

— Not subject to takeover legislation (but may be subject to stock exchange listing rules).

— May qualify as a GST-free supply of a going concern.

— May minimize GST leakage on transaction costs.

Disadvantages of asset purchases

— Complexity of renegotiating/transferring supply, employment, technology and other agreements.

— Higher rates of transfer (stamp) duties.

— Benefit of any losses incurred by the target company remains with the seller.

— Need to consider whether the GST going concern exemption is available.

Advantages of share purchases

— Lower capital outlay (purchase net assets only).

— Potential to step-up the tax value of certain assets in a 100 percent acquisition.

— Less complex contractually and likely more attractive to seller.

— May benefit from tax losses of the target company (unless the target company was a member of a tax-consolidated group).

— Lower or no stamp duties payable (if not predominantly land).

— Acquisition of shares should be either input taxed (exempt) or GST-free (zero rated).

Disadvantages of share purchases

— Liable for any historic claims or liabilities of the entity, including joint and several liability for tax debts of seller's consolidated group where no valid tax-sharing agreement exists.

— Target company losses remain with the seller where the target company exits the seller's tax consolidated group.

— GST leakage may arise on transaction costs if full input tax credits are not available.

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New Zealand

Introduction

This report addresses three fundamental decisions that face a prospective buyer:

— What should be acquired: the target's shares or its assets?

— What will be the acquisition vehicle?

— How should the acquisition vehicle be financed?

Of course, tax is only one piece of transaction structuring. Company law governs the legal form of a transaction, and accounting issues are also highly relevant when selecting the optimal structure. These areas are outside the scope of this report, but some of the key points that arise when planning the steps in a transaction plan are summarized later in this report.

Recent developments

New Zealand's recent tax developments with regard to mergers and acquisitions (M&A) are set out in the relevant sections of this report.

Case law

A number of court wins for the Inland Revenue Department (IRD) on the application of New Zealand's general tax anti-avoidance rule have implications for transactions and structures adopted for inbound investment. For example, the New Zealand Court of Appeal decision in *Alesco* v CIR involved a taxpayer unsuccessfully appealing a tax avoidance finding on the use of cross-border optional convertible notes as a funding structure.

A greater level of consideration has been given by the courts (and IRD) to what is regarded as the commercial reality and economic effects of transactions. Reliance on the legal form of the transaction or the structure used is no longer a suitable defense. This has inevitably increased uncertainty over what is acceptable tax planning.

Base erosion and profit shifting

The New Zealand government, like most other Organisation for Economic Co-operation and Development (OECD) countries, has expressed concern about the impact of base erosion and profit shifting (BEPS) by multinationals. New Zealand is engaging with the OECD on its Action Plan on BEPS.[1]

Legislatively, changes have been made to tighten the interest deductibility rules for non-residents, by extending New Zealand's thin capitalization rules to groups of non-residents 'acting together'. Changes have also been made to non-resident withholding tax (NRWT) rules, aimed at removing the ability for non-residents to shift profits out of New Zealand with no or minimal tax paid under the NRWT rules.

Further draft legislation has recently been introduced to prevent multinationals from using:

— artificially high interest rates on loans from related parties to shift profits out of New Zealand

— hybrid mismatch arrangements that exploit differences between countries' tax rules to achieve an advantageous tax position

— artificial arrangements to avoid having a taxable presence in New Zealand

— related-party transactions to shift profits into offshore group members in a manner that does not reflect the actual economic activities taken in New Zealand and offshore.

Once enacted, these measures are generally intended to take effect from 1 July 2018.

New Zealand is also a signatory to the OECD Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (BEPS), although it is not yet in force.

Inland Revenue activity

In its annual tax compliance guide for businesses, the IRD has focused on aggressive tax planning (e.g. financing and transfer pricing transactions by multinationals). The IRD's focus areas largely align with the OECD's key areas of concerns.

Therefore, for non-residents looking to invest in New Zealand, attention needs to be given to 'future-proofing' inbound investment structures, in view of expected legislative changes.

From a New Zealand tax perspective, factors that may influence cross-border inbound investment decisions include:

— comparative methods of funding the investment

— type of operating entity best suited to a particular investment

[1] http://www.oecd.org/BEPSActionPlan.pdf

— quantum of tax arising when profits are distributed

— alternatives available for realizing the investment and repatriating the proceeds.

Tax Working Group

New Zealand's new government, elected in September 2017, promised a comprehensive review of the New Zealand tax system by a Tax Working Group. The terms of reference for the Tax Working Group exclude increases to any income tax rate, the rate of GST and inheritance tax, and changes that affect the family home or land beneath it. All other areas of New Zealand tax law are potentially within the scope of the review.

The Tax Working Group's interim report is due to the government by September 2018, with a final report to be issued no later than February 2019. The government has announced that any significant changes proposed by the Tax Working Group would not be implemented until after the 2020 election.

Update of New Zealand's treaty network

New Zealand has signed new tax treaties with Canada, Japan, Papua New Guinea, Samoa and Vietnam.

The most significant changes in the new treaties are to withholding tax (WHT) rates, with reductions in rates for dividends, interest and royalties. These new treaties also contain anti-treaty shopping rules.

Ongoing discussions to update and revise existing tax treaties continue in respect of a number of major jurisdictions including China, the United Kingdom and the Netherlands. Negotiations of a tax treaty with Luxembourg are ongoing.

New Zealand has significantly expanded its tax information exchange agreement (TIEA) network in recent years. TIEAs were signed with a number of traditional offshore jurisdictions, including the British Virgin Islands, Cayman Islands and Jersey. Negotiations for TIEAs with Monaco and Macao, among other jurisdictions, are underway.

Asset purchase or share purchase

New Zealand does not have a comprehensive capital gains tax. As a result, gains on capital assets are subject to tax only in certain limited instances, for example, where the business of the taxpayer comprises or includes dealing in capital assets, such as shares or land, or where the asset is acquired for the purpose of resale. The fact that capital gains are usually not subject to tax in New Zealand has an impact on the asset versus share purchase decision.

Purchase of assets (excluding land)

A purchase of assets usually results in the base cost of those assets being reset at the purchase price for tax depreciation (capital allowance) purposes. This may result in a step-up in the cost base of the assets (although any increase may be taxable to the seller).

Historical tax liabilities generally remain with the company and are not transferred with the assets. The buyer may still inherit defective practices or compliance procedures. Thus, a buyer may wish to carry out some tax due diligence to identify and address such weaknesses (e.g. through appropriate indemnities).

Purchase of land

A purchase of land usually results in the base cost being reset at the purchase price. However, there is no allowance for tax depreciation for land or buildings with an estimated useful life of 50 years or more (see further below).

There are disclosure requirements on transferors and transferees of New Zealand land. The requirements include buyers and sellers' tax details, such as their New Zealand IRD number, tax residence status and foreign tax information if non-resident (e.g. the country of tax residence and foreign tax identification number).

All buyers and sellers, including non-residents, must provide a New Zealand IRD number. To receive an IRD number, a non-resident must have a fully functioning New Zealand bank account (i.e. capable of withdrawals as well as deposits) and provide evidence of this to Inland Revenue. This requires having the New Zealand bank confirm the non-resident's identity through anti-money laundering and countering financing of terrorism checks. Alternatively, a non-resident applying for an IRD number can request a customer due diligence certificate from an IRD-approved reporting entity. This certificate confirms that the reporting entity has completed due diligence on the non-resident applicant in accordance with the Anti-Money Laundering and Countering Financing of Terrorism Act 2009.

Purchase price

No statutory rules prescribe how the purchase price is to be allocated among the various assets purchased. Where the sale and purchase agreement is silent as to the allocation of the price, the IRD generally accepts a simple pro rata allocation between the various assets purchased on the basis of their respective market values.

Goodwill

Goodwill paid for a business as a going concern is not deductible, depreciable or amortizable for tax purposes. For this reason, where the price contains an element of goodwill, it is common practice for the buyer to endeavor to have the purchase and sale agreement properly allocate the purchase price between the tangible assets and goodwill to be acquired.

This practice is not normally challenged by the IRD, provided that the purchase price allocation is agreed between the parties and reasonably reflects the assets' market values.

If the sale and purchase agreement is silent as to the allocation of the price, a simple pro rata allocation between

the various assets purchased, on the basis of their respective market values, is usually accepted.

It may be possible to structure the acquisition of a New Zealand investment in such a way as to reduce the amount of goodwill that is acquired. Given that certain intangible assets can be depreciated in New Zealand (see later in this report), a sale and purchase agreement could apportion part of the acquisition price to certain depreciable intangible assets, rather than non-depreciable goodwill.

Depreciation

Most tangible assets may be depreciated for income tax purposes, the major exceptions being land and, more recently, buildings (see below). Rates of depreciation vary depending on the asset. Taxpayers are free to depreciate their assets on either a straight-line or diminishing-value basis.

As of the 2011–12 income year, no depreciation can be claimed on buildings with an estimated useful life of 50 years or more. (Building owners can continue to depreciate 15 percent of the building's adjusted tax value at 2 percent per year where all items of building fit-out, at the time the building was acquired, have historically been depreciated as part of the building.)

Capital contributions toward depreciable property must be treated by the recipient as income spread evenly over 10 years or as a reduction in the depreciation base of the asset to which the contribution relates. (Examples include capital contributions payable to utilities providers by businesses to connect to a network.)

While the cost of intangible assets generally cannot be deducted or amortized, it is possible to depreciate certain intangible assets. The following assets (acquired or created after 1 April 1993) may qualify for an annual depreciation deduction, subject to certain conditions:

— the right to use a copyright

— the right to use a design model, plan, secret formula or process or any other property right

— a patent or the right to use a patent

— a patent application with a complete specification lodged on or after 1 April 2005

— the right to use land

— the right to use plant and machinery

— the copyright in software, the right to use the copyright in software, or the right to use software

— the right to use a trademark.

Other intangible rights that qualify for an annual depreciation deduction include:

— management rights or license rights created under the Radio Communications Act 1989

— certain resource consents granted under the Resource Management Act 1991

— the copyright in a sound recording (in certain circumstances)

— plant variety rights, or the right to use plant variety rights, granted under the Plant Variety Rights Act 1987 or similar rights given similar protection under the laws of a country or territory other than New Zealand as of the 2005–06 income year.

Depreciation may be recovered as income (known as 'depreciation recovery income') where the disposal of an asset yields proceeds in excess of its adjusted tax value. Special rules apply to capture depreciation recovery income for depreciation previously allowed for software acquired before 1 April 1993 and the amount of any capital contribution received for that item.

Tax attributes

Tax losses and imputation credits are not transferred on an asset acquisition. They remain with the company.

Value added tax

New Zealand has a value added tax (VAT), known as the Goods and Services Tax (GST). The rate is currently 15 percent and must be charged on most supplies of goods and services made by persons who are registered for GST.

The sale of core business assets to a buyer by a registered person constitutes a supply of goods for GST purposes and, in the absence of any special rules, is charged with GST at the standard rate.

However, if the business is a going concern, it can be zero-rated by the seller (charged with GST but at 0 percent). To qualify for zero-rating:

— both the seller and buyer must be registered for GST

— the seller and buyer must agree in writing that the supply is of a going concern

— the business must be a going concern

— the buyer and seller must intend that the buyer should be capable of carrying on the business.

Sales consisting wholly or partly of land must be zero-rated by the seller where both the seller and the buyer are registered for GST at the time of settlement and the buyer intends to use the property for GST taxable supply purposes.

'Land' is defined broadly and includes a transfer of a freehold interest and, in most circumstances, the assignment of a lease but not periodic lease payments.

Where the sale is of land and other assets, then the whole sale must be zero rated, not just the land component.

As the GST risk is with the seller if it incorrectly zero-rates the supply, the buyer must provide a written statement to the seller attesting to the following points:

— the buyer is a registered person or will be registered at the time of settlement

— the buyer is acquiring the land with the intention of using it to make taxable supplies

— the buyer does not intend to use the land as their own or an associate's principal place of residence.

If the sale is to a nominee, then it is the status of the nominee that is relevant.

In most cases, the purchase price is expressed as 'plus GST', if any, thereby granting the seller the right to recover from the buyer any GST later assessed by the IRD. However, this must be expressly stated. If the contract is silent, the price is deemed to be inclusive of GST.

Where the sale of assets cannot be zero-rated, the buyer may recover the GST paid to the seller from the IRD, provided the buyer is registered for GST or is required to be registered for GST at the time the assets are supplied by the seller. Goods and services are supplied at the earlier of the time that the seller receives a payment (including a deposit) or the seller issues an invoice. An invoice is defined as a document giving notice of an obligation to make a payment.

Assets imported into New Zealand are subject to GST of 15 percent at the border.

New Zealand has a reverse charge on imported services to align the treatment of goods and services. However, the impact of the GST on imported services affects only organizations that make GST-exempt supplies (e.g. financial institutions). Organizations that do not make GST-exempt supplies are not required to pay a reverse charge.

Transfer taxes

No stamp duty is payable on sales of land, improvements or other assets.

Purchase of shares

The purchase of a target company's shares does not result in an increase in the base cost of the company's underlying assets; there is no deduction for the difference between underlying net asset values and consideration, if any.

Tax indemnities and warranties

In a share acquisition, the buyer acquires the target company together with all related liabilities including contingent liabilities. Consequently, in the case of negotiated acquisitions, it is usual for the buyer to request, and the seller to provide, indemnities and/or warranties in respect of any historical taxation positions and taxation liabilities of the company to be acquired. The extent of the indemnities and warranties is a matter for negotiation.

Tax losses

To carry forward tax losses from 1 income year to the next, a company must maintain a minimum 49 percent shareholder continuity from the start of the income year in which the tax losses were incurred. Unlike some jurisdictions, New Zealand does not have a same-business test, so the ability to carry forward and use tax losses is solely based on the shareholder continuity percentage.

Where there is a minimum 66 percent commonality of shareholding from the beginning of the income year in which the tax losses were incurred, a company potentially can offset its tax losses with another group company. It is difficult to preserve the value of tax losses post-acquisition, as there is limited scope to refresh tax losses.

Crystallization of tax charges

Caution should be exercised where the buyer is acquiring shares in a company that is a member of a consolidated income tax group, because the target company will remain jointly and severally liable for the income tax liability of the consolidated income tax group that arose when the target company was a member. The IRD may grant approval for the target company to cease to be jointly and severally liable.

In addition, a comprehensive set of rules applies to capture income arising on the transfer of certain assets out of a consolidated tax group where they have previously been transferred within the consolidated tax group to the departing member of that group. The disposal of shares in a company holding the transferred assets constitutes a sale of that asset out of the consolidated tax group; for tax purposes, the company is deemed to have disposed of the asset immediately before it leaves the consolidated tax group and to have immediately reacquired it at its market value. This rule applies to transfers of 'financial arrangements' (e.g. loans), depreciable property and, in some situations, trading stock, land and other revenue assets.

Pre-sale dividend

New Zealand operates an imputation system of company taxation. Shareholders of a company gain relief against their own New Zealand income tax liability for income tax paid by the company. Tax payments by the company are tracked in a memorandum account, called an 'imputation credit account', which records the amount of company tax paid that may be imputed to dividends paid to shareholders. New Zealand-resident investors use imputation credits attached to dividends to reduce the tax payable on the dividend income.

To carry forward imputation credits from 1 imputation year to the next, a company must maintain a minimum of 66 percent shareholder continuity from the date the imputation credits are generated.

Where imputation credits are to be forfeited (e.g. on a share sale that will breach the minimum 66 percent shareholder continuity), then a taxable bonus issue (TBI) generally may be used to preserve the value of the imputation credits that would otherwise be lost.

The advantage of a TBI is that it achieves the same outcome as a dividend in respect of crystallizing the value of imputation

credits for the ultimate benefit of the company's shareholders. However, since a TBI does not require cash to be paid, the solvency of the company is not adversely affected and there is no WHT cost.

The TBI essentially converts retained earnings to available subscribed capital (ASC) for income tax purposes. This ASC can then be distributed tax-free to the company's shareholder(s) in the future (e.g. on liquidation of the company or as part of a capital reduction), where certain conditions are met.

The TBI provides a potential benefit to the buyer but no benefit to the seller. This is something the buyer may need to raise with the seller.

Transfer taxes

No stamp duty is payable on transfers of shares or on the issue of new shares.

Tax clearances

A party to a transaction can seek a binding ruling from the IRD on the tax consequences of an acquisition or merger. However, it is not possible to obtain an assurance from the IRD that a potential target company has no arrears of tax and is not involved in a tax dispute.

Choice of acquisition vehicle

The following vehicles may be used to acquire the shares and/or assets of the target:

— local holding company

— foreign parent company

— non-resident intermediate holding company

— branch

— joint venture

— other special purpose vehicles (e.g. partnership, trust or unit trust).

Local holding company

Subject to thin capitalization requirements, a local holding company may be used as a mechanism to allocate interest-bearing debt to New Zealand (i.e. the local holding company borrows money to help fund the acquisition of the New Zealand target).

From a New Zealand perspective, a tax-efficient exit strategy involves selling the shares of the local holding company as opposed to selling the shares of the underlying operating subsidiary. Where the shares in the underlying operating subsidiary are sold, a WHT liability arises on the repatriation of any capital profit unless an applicable tax treaty reduces the WHT rate (potentially to 0 percent; see below).

The imputation credit regime reduces the impact of double tax for New Zealand-resident shareholders. New Zealand-resident investors use imputation credits attached to dividends to reduce the tax payable on dividend income received from New Zealand-resident companies.

For non-resident shareholders, dividends are subject to NRWT at either 15 percent if fully imputed or 30 percent if not (most tax treaties limit this rate to 15 percent or less in the case of some recently renegotiated treaties).

The domestic rate of NRWT payable is 0 percent where a dividend is fully imputed and a non-resident investor holds a 10 percent or greater voting interest in the company (or where the shareholding is less than 10 percent but the applicable post-treaty WHT rate on the dividend is less than 15 percent; New Zealand currently has no such treaties).

For non-resident investors with shareholdings of less than 10 percent, the 15 percent WHT rate on fully imputed dividends can be relieved under the foreign investor tax credit (FITC) regime. This regime essentially eliminates NRWT by granting the dividend-paying company a credit against its own income tax liability where the company also pays a 'supplementary dividend' (equal to the overall NRWT charge) to the non-resident.

For GST purposes, the holding company and the operating company should be grouped. This allows the holding company to recover GST on expenses paid. Alternatively, a management fee may be charged from the holding company to the operating company.

Foreign parent company

The foreign buyer may choose to make the acquisition itself, perhaps to shelter its own taxable profits with the financing costs.

Non-resident intermediate holding company

Where the foreign country taxes capital gains and dividends received from overseas, an intermediate holding company resident in another territory could be used to defer this tax and perhaps take advantage of a more favorable tax treaty with New Zealand. However, as noted earlier, increased attention is being paid globally to structures in an effort to target BEPs concerns. In addition, most new tax treaties have anti-treaty shopping provisions that may restrict the ability to structure a deal in a way designed solely to obtain tax benefits.

Local branch

New Zealand-resident companies and branches established by offshore companies are subject to income tax at 28 percent of taxable profits.

In most cases, the choice between operating a New Zealand company or branch is neutral for New Zealand tax purposes because of the changes to the domestic NRWT rules (for shareholdings of 10 percent or more; see local holding company section) and the application of the FITC regime (for shareholdings less than 10 percent).

A branch is not a separate legal entity, so its repatriation of profits is not considered a dividend to a foreign company and

NRWT is not imposed. The effective tax rate on a New Zealand branch operation is therefore 28 percent.

In effect, New Zealand's thin capitalization and transfer pricing regimes apply equally to branch and subsidiary operations. In practice, however, the application of New Zealand's transfer pricing rules to branches and subsidiaries can differ in some respects.

Joint venture

Where an acquisition is to be made in conjunction with another party, the question arises as to the most appropriate vehicle for the joint venture. Although a partnership can be used, in most cases, the parties prefer to conduct the joint venture via a limited liability company, which offers the advantages of incorporation and limited liability for its members. In contrast, a general partnership has no separate legal existence and the partners are jointly and severally liable for the debts of the partnership, without limitation.

Limited partnership

New Zealand has special rules for limited partnerships that may make them more attractive than general partnerships for joint venture investors. The key features of limited partnerships are as follows:

— Limited partners' liability is limited to the amount of their contributions to the partnership.

— Limited partners are prohibited from participating in the management of the limited partnership. They may undertake certain activities (safe harbors) that allow them to have a say in how the partnership is run without being treated as participating in the management of the partnership and losing their limited liability status.

— A limited partnership is a separate legal entity to provide further protection for the liability of limited partners.

— Each partner in a limited partnership is taxed individually, in proportion to their share of the partnership income, in the same way that income from general partnerships is taxed.

— Limited partners' tax losses in any given year are restricted to the level of their economic loss in that year.

By contrast, an incorporated joint venture vehicle does not offer the same flexibility in respect of the offset of tax losses. Grouping of tax losses arising in a company is limited to the extent that the loss company and the other company were at least 66 percent commonly owned in the income year in which the loss arose and at all times up to and including the year in which the loss offset arises.

A key issue with limited partnership structures is that thin capitalization is tested for each partner (not the limited partnership), which may restrict the ability to gear New Zealand investments without loss of interest deductions. The thin capitalization rules are discussed later in this report.

Choice of acquisition funding

A buyer using a New Zealand acquisition vehicle to carry out an acquisition for cash needs to decide whether to fund the vehicle with debt, equity or a hybrid instrument that combines the characteristics of both (care should be taken with hybrid instruments given the proposed legislative changes discussed above). The principles underlying these approaches are discussed later in this report.

Recent changes allow for the recovery of GST paid on costs incurred in issuing or acquiring debt instruments or issuing equity instruments to the extent that the funds raised are expended in an activity of making taxable supplies for GST purposes.

GST on equity acquisition costs (including evaluation of the investment) is recoverable where there is an acquisition of an interest of greater than 10 percent, the investor is able to influence management, and the shares are acquired in a non-resident or in an entity that makes more than 75 percent taxable supplies.

Debt

The principal advantage of debt is the availability of tax deductions for interest (see deductibility of interest below). In addition, a deduction is available for expenditure incurred in arranging financing in certain circumstances. In contrast, the payment of a dividend does not give rise to a tax deduction.

To fully utilize the benefit of tax deductions on interest payments, it is important to ensure that there are sufficient taxable profits against which the deductions may be offset.

In an acquisition, it is more common for borrowings to be undertaken by the new parent of the target (rather than the target itself) and for any cash flow requirements of the borrowing parent to be met by extracting dividends from the target. Provided the companies are part of a wholly owned group, dividends between the companies are exempt.

Deductibility of interest

Subject to the thin capitalization and transfer pricing regimes (discussed later in this report), most companies can claim a full tax deduction for all interest paid, without regard to the use of the borrowed funds. For other taxpayers, the general interest deductibility rules apply. These rules allow an interest deduction where interest is:

— incurred in gaining or producing assessable income or excluded income for any income year

— incurred in the course of carrying on a business for the purpose of deriving assessable income or excluded income for any income year

— payable by one company in a group of companies on monies borrowed to acquire shares in another company included in that group of companies (a company deriving only exempt income can only deduct interest in limited situations, e.g. where the exempt income is from dividends).

Where a local company is thinly capitalized, interest deductions are effectively removed through the creation of income to the extent that the level of debt exceeds the thin capitalization 'safe harbor' debt percentage. Generally, a New Zealand company is regarded as thinly capitalized where it exceeds a safe harbor of 60 percent in respect of its debt percentage and the applicable debt percentage for the New Zealand group also exceeds 110 percent of the debt percentage for the worldwide group.

As of 1 April 2015, debt originating from shareholders is excluded when calculating the debt level of a company's worldwide operations.

The inbound thin capitalization regime also applies when non-residents who appear to be acting together own 50 percent or more of a company. Non-residents are treated as acting together if they hold debt in a company in proportion to their equity, have entered into an arrangement setting out how to fund the company with related-party debt, or act on the instructions of another person (i.e. a private equity manager) in funding the company with related-party debt. Increases in asset values following internal company reorganizations are ignored, unless the increase in asset value would be allowed under generally accepted accounting principles in the absence of the reorganization, or if the reorganization is part of the purchase of the company by a third party.

The thin capitalization rules also apply to outbound investment by a New Zealand company, i.e., where a New Zealand parent debt-funds its offshore operations. In this case, the relevant debt percentage is 75 percent. An additional safe harbor applies for outbound investments, provided the ratio of assets in the New Zealand group is 90 percent or more of the assets held in the worldwide group and the interest deductions are less than 250,000 New Zealand dollars (NZD).

There is an alternative thin capitalization test for New Zealand companies with outbound investments that have high levels of arm's length debt (provided certain other conditions are met). These companies can choose a test for thin capitalization based on a ratio of their interest expenses to pre-tax cash flows, rather than on a debt-to-asset ratio.

Where a New Zealand company becomes subject to inbound thin capitalization due to ownership by a non-resident owning body, it must treat its New Zealand group assets/debt as its worldwide group assets/debt when applying the 110 percent of the worldwide group debt percentage safe harbor test.

Generally, the funding of a subsidiary by a parent through the use of interest-free loans does not produce any adverse taxation consequences. Such loans are not included in thin capitalization calculations for New Zealand income tax purposes. However, an interest-free loan from a subsidiary to its parent could be deemed to be a dividend, thereby creating assessable income for the parent company. Such transactions are also potentially subject to the transfer pricing regime where the counterparty is a non-resident.

The timing of the deductibility of interest on financial arrangements (widely defined to include most forms of debt) is governed by legislation known as the 'financial arrangements' rules.

These rules require that interest be calculated in accordance with one of the prescribed spreading methods. These rules do not apply to non-residents, except in relation to financial arrangements entered into by non-residents for the purpose of a fixed establishment (i.e. branch) situated in New Zealand.

A number of changes are currently proposed to the thin capitalization regime as part of IRD's BEPS focus. The major change is the deduction of non-debt liabilities from the calculation of total assets for the purposes of calculating the group debt percentage. Non-debt liabilities include all non-interest-bearing liabilities, except some shareholder loans, liabilities for shares (e.g. redeemable preference shares), provisions for dividends, and some deferred tax liabilities.

Once enacted, the proposed changes are intended to take effect from 1 July 2018.

Withholding tax on debt and methods to reduce or eliminate it

WHT is imposed on interest payments and dividend distributions between New Zealand residents (with some exceptions) unless a certificate of exemption is obtained.

Entities with gross assessable income (before deductions) of NZD2 million or more are entitled to an exemption certificate, as are financial institutions, exempt entities, entities in loss situations and certain others. Interest payments and dividend distributions paid and received by companies within the same wholly owned group are not subject to WHT.

NRWT is imposed on interest, dividends and royalties paid to non-residents (including income arising under the financial arrangements rules). The domestic rate of NRWT on payments of interest is 15 percent; however, most tax treaties reduce this rate to 10 percent (and 0 percent in some recent tax treaties in cases where the lender is a financial institution that is not associated with the borrower).

There are limited opportunities to reduce the NRWT on payments of interest by a New Zealand-resident payer to a related non-resident recipient.

The approved issuer levy (AIL) regime can be applied instead of NRWT in the case of interest payments to non-residents who are not associated with the New Zealand payer. On confirmation of 'approved issuer' status by the IRD, interest payments to the relevant non-resident lender are exempt from NRWT and instead subject to the payment of a levy equal to 2 percent of the interest.

AIL cannot be applied to:

— back-to-back loans involving third-party lenders if a non-resident associate of the New Zealand borrower provides funds to the third-party lender

— loans made by a group owning more than 50 percent of the New Zealand resident borrower and 'acting together', mirroring recent thin capitalization rule changes.

Checklist for debt funding

— The use of local bank debt may avoid transfer pricing problems and should obviate the requirement to withhold tax from interest payments.

— Holding company tax losses not used in the current year may be carried forward and offset against a group company's future profits, subject to shareholder continuity and commonality rules.

— The buyer should consider whether the level of profits would enable tax relief for interest payments to be effective.

— A tax deduction may be available at higher rates in other territories.

— WHT of 15, 10, or 5 percent or, in some cases, 2 percent (under AIL) applies on interest payments to non-New Zealand entities.

Equity

Dividends and certain bonus share issues are included in taxable income. Payments of dividends are not deductible. Tax assessed on a dividend may be offset by any imputation credits attached to the dividend of the payer company. There are two main exemptions to the taxability of dividends for companies. These apply when:

— both the payer and recipient company are in a wholly owned group (i.e. same ultimate ownership)

— dividends are received from offshore companies (subject to minor exceptions).

The income tax exemption for foreign dividends applies for income years beginning on or after 1 July 2009 (aligned to the start date of New Zealand's current controlled foreign company (CFC) regime). Before the exemption was introduced, a 'foreign dividend withholding payment' was required to be made by a New Zealand company on receipt of a foreign dividend.

Withholding tax on dividend distributions and methods to reduce or eliminate it

WHT is generally imposed on dividend payments between New Zealand residents (as described earlier). For non-resident shareholders, dividends are subject to NRWT at 15 percent, where fully imputed.

The domestic rate of NRWT payable is 0 percent where a dividend is fully imputed and a non-resident investor holds a 10 percent or greater voting interest in the company (or where the shareholding is less than 10 percent but the applicable post-treaty WHT rate on the dividend is less than 15 percent; New Zealand currently has no such treaties).

For non-resident investors with shareholdings of less than 10 percent, the 15 percent WHT rate on fully imputed dividends can be relieved under the FITC regime, which eliminates the NRWT by granting the dividend-paying company a credit against its own income tax liability where the company also pays a supplementary dividend (equal to the overall NRWT charge) to the non-resident.

A 30 percent NRWT rate applies to unimputed dividends, but most tax treaties limit this to 15 percent or, in recently negotiated treaties, lower.

Selection of a favorable tax treaty jurisdiction for the establishment of a non-resident shareholder may be considered to reduce or eliminate this tax. The buyer should be aware of the increased international focus on BEPs and the use of tax treaties to obtain tax advantages.

Accordingly, New Zealand's new tax treaties contain explicit anti-treaty shopping provisions (i.e. limitation on benefits clauses and beneficial ownership requirements), including recently renegotiated treaties with Australia, the United States, Singapore and Hong Kong (SAR) due to their lower WHT rates.

The IRD also recently amended the domestic anti-avoidance law to explicitly override benefits obtained under tax treaties in treaty shopping cases.

Corporate migration

A New Zealand-incorporated company can transfer its incorporation from the New Zealand Companies' Register and become registered on a register of overseas companies. Such a company is no longer considered to be incorporated in New Zealand and, provided the other tests for tax residence are not met, becomes a non-resident for New Zealand tax purposes. This process is known as 'corporate migration'.

A corporate migration is treated as a deemed liquidation of all assets of the company followed by a deemed distribution of the net proceeds. Income tax consequences such as clawback arise (e.g. depreciation clawback) and NRWT obligations are imposed on the deemed distribution to the extent it exceeds a return of capital for tax purposes. The amount subject to NRWT typically includes the distribution of retained earnings and, for shareholders owning 20 percent or more of the liquidating company, capital reserves. The WHT cost may be reduced by attaching imputation credits to the deemed dividend distribution (or under New Zealand's tax treaty).

Hybrids

Hybrid instruments (except options over shares) are deemed to be either shares (treated as equity) or debt (subject to the financial arrangements rules). Various hybrid instruments and structures potentially offer an interest deduction for the borrower with no income pick-up for the lender. However, proposed legislative changes that aim to address BEPS will largely negate the benefits of hybrid instruments going forward.

KPMG in New Zealand recommends obtaining specialist advice where such financing techniques are contemplated or are already in place.

Common types of instruments and their tax treatment are as follows.

Type	Treatment
Convertible note	Debt, subject to financial arrangements rules; possible equity gain on conversion
Perpetual debt	Debt, subject to financial arrangements rules
Subordinated debt	Debt, subject to financial arrangements rules
Floating rate debenture	Deemed to be shares where the rate is linked to profits or dividends of issuer; otherwise debt, subject to financial arrangements rules
Share option	Not subject to financial arrangements rules (gain or loss is generally capital and may be neither assessable nor deductible unless issued to employees, in which case any benefit is taxed as remuneration)
Others	Usually debt, subject to financial arrangements rules

Discounted securities

Interest deductions are available for discounted securities as determined on an accrual basis over the term of the security. The applicable spreading method for recognition of the deduction is prescribed under the financial arrangements rules.

Deferred settlement

Where settlement is to be deferred, the financial arrangements rules may deem a part of the purchase price to be interest payable to the seller.

This may be avoided by having the sale and purchase agreement specifically state whether interest is payable and, if so, the terms. This generally gives rise to a 'lowest price clause' in the sale and purchase agreement, stating that no interest is payable due to the deferred settlement. However, from the buyer's perspective, it may be desirable to have an element of the purchase price deemed to be interest payable to the seller, as this may give rise to a deduction of the portion of the purchase price deemed to be interest.

For deferred property settlements denominated in a foreign currency, as of the 2014–2015 income year (or earlier income years if elected by the taxpayer), buyers using International Financial Reporting Standards (IFRS) are required to follow their accounting treatment to recognize interest and/or foreign currency fluctuations arising in relation to the agreement.

Consolidated income tax group

Two or more companies that are members of a wholly owned group of companies may elect to form a consolidated group for taxation purposes. The effect of this election is that the companies are treated for income tax purposes as if they were one company. The group only has to file one income tax return and receives one tax assessment. However, all members of the group become jointly and severally liable for the entire group's taxation liabilities. Approval may be sought from the IRD for one or more group companies to be relieved from joint and several liability in certain circumstances.

Intragroup transactions are disregarded for income tax purposes, although asset transfers result in deferred income tax liabilities. For a consolidated group, the income tax impact of intercompany asset transfers arises when the company that was the recipient of any asset leaves the consolidated group while still holding the property acquired, or when the asset itself is sold.

The main advantage of consolidation is that assets can be transferred at tax book value between consolidated group companies. Companies that are not part of such a regime must transfer assets at market value, realizing a loss or gain on the transaction for income tax purposes.

Note that this only consolidates income tax. Other taxes still need to be reported individually (unless the relevant tax (e.g. GST) allows grouping under its rules and IRD approval is sought).

Concerns of the seller

When a purchase of assets is contemplated, as opposed to the purchase of shares, the seller's main concern is likely to be the recovery of tax-depreciation (assessable income) if the assets are sold for more than their book value for tax purposes.

Company law and accounting

Company law

The Companies Act 1993 prescribes how New Zealand companies may be formed, operated, reorganized and dissolved.

Merger

A merger usually involves the formation of a new holding company to acquire the shares of the parties to the merger and is usually achieved by issuing shares in the new company to the shareholders of the merging companies. Once this step is completed, the new company may have the old companies wound up and their assets distributed to the new company. Certain companies (i.e. 'Code Companies', as defined) must comply with the obligations of the Takeovers Code.

Acquisition

A takeover involving large, publicly listed companies may be achieved by the bidder offering cash, shares or a mixture of the two. Acquisitions involving smaller or privately owned companies are accomplished in a variety of ways and may involve the acquisition of either the shares in the target company or its assets. Again, Code Companies need to comply with the obligations of the Takeovers Code.

Amalgamation

An amalgamation is a statutory reorganization under New Zealand law. Concessionary tax rules facilitate amalgamations. In New Zealand, an amalgamation involves a transfer of the business and assets of one or more companies to either a new company or an existing company.

All amalgamating companies cease to exist on amalgamation (unless one of them becomes the amalgamated company), with the new amalgamated company becoming entitled to and responsible for all the rights and obligations of the amalgamating companies.

Accounting

Consideration should be given to any potential impact that IFRS may have on asset valuations and thus on how the deal should be structured. For example, is any goodwill on acquisition recorded as an asset in a New Zealand entity's financial statements, and is there a potential impact on asset valuations for thin capitalization purposes?

Group relief/consolidation

Companies form a group for taxation purposes where at least 66 percent commonality of shareholding exists. The profits of one group company can be offset against the losses of another by the profit company making a payment to the loss company. Alternatively, a loss company can make an irrevocable election directly to offset its losses against the profits of a group profit company. Companies must be members of the group from the commencement of the year of loss until the end of the year the loss is offset.

There is no requirement to form a consolidated tax group in order to offset losses.

Transfer pricing

New Zealand has a comprehensive transfer pricing regime based on the OECD's transfer pricing guidelines.

Generally, the transfer pricing regime applies to cross-border transactions between related parties that are not at an arm's length price (e.g. the New Zealand company does not receive adequate compensation from, or is overcharged by, the foreign parent/group company). Two companies are generally considered related for transfer pricing purposes where there is a group of persons with voting (or market value) interests of 50 percent or more in both companies.

Where transaction prices are found not to be at arm's length, the transfer pricing rules enable the IRD to reassess a taxpayer's income to ensure that New Zealand's tax base is not eroded. In recent years, the rates of interest charged on intercompany lending have come under increased focus by the IRD.

Dual residency

New Zealand has an anti-avoidance rule that prevents a dual resident company from offsetting its losses against the profits of another company.

Foreign investments of a local target company

New Zealand's CFC regime attributes the income of an offshore subsidiary to its New Zealand-resident shareholder in certain circumstances.

A company is regarded as a CFC for New Zealand purposes where the New Zealand-resident shareholder meets certain control tests (i.e. one shareholder holds 40 percent or more of the voting interest or five or fewer shareholders collectively hold more than 50 percent voting interests).

An 'active' income exemption applies to profits from a CFC, under which:

- income must only be attributed where 5 percent or more of the CFC's income is 'passive' (e.g. from dividends, rents, interest, royalties and other financial income; only passive income is attributed if the test is failed)
- dividends from CFCs are exempt
- there is a general exemption from the active income test where the CFC is resident and liable to tax in Australia
- outbound thin capitalization rules apply.

Comparison of asset and share purchases

Advantages of asset purchases

- The purchase price (or a proportion) can be depreciated or amortized for tax purposes (but not goodwill).
- A deduction is gained for trading stock purchased.
- No previous liabilities of the company are inherited.
- No future tax liability on retained earnings is acquired.
- Possible to acquire only part of a business.
- Greater flexibility in funding options.
- Profitable operations can be absorbed by loss companies in the acquirer's group, thereby effectively gaining the ability to use the losses.

Disadvantages of asset purchases

- Possible need to renegotiate supply, employment and technology agreements.
- A higher capital outlay is usually involved (unless debts of the business are also assumed).
- May be unattractive to the seller, thereby increasing the price.

— Accounting profits may be affected by the creation of acquisition goodwill.

— GST may apply to the purchase price, giving rise to a possible cash flow cost, even where the buyer can claim the GST.

Advantages of share purchases

— Lower capital outlay (purchase of net assets only).

— Likely to be more attractive to the seller, which should be reflected in the price.

— May gain benefit of existing supply or technology contracts.

Disadvantage of share purchases

— Acquire potential unrealized tax liability for depreciation recovery on the difference between market and tax book value of assets (if deferred tax accounting is applied, this should be reflected in the net assets acquired).

— Subject to warranties and indemnities, buyer could acquire historical tax and other risks of the company.

— Liable for any claims on or previous liabilities of the entity.

— No deduction for the purchase price.

— Acquire tax liability on retained earnings that are ultimately distributed to shareholders.

— Less flexibility in funding options.

— Losses incurred by any companies in the acquirer's group in the target's pre-acquisition years cannot be offset against any profits made by the target company.

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