A strategy for cross-border acquisitions

Stephen Weston of Arthur Andersen takes a closer look at the potential tax issues involved in cross-border acquisition structuring.

Tax can have a significant role in acquisition structuring once a deal has been identified. This article sets out the basic tax issues on which to focus and outlines some cross-border planning opportunities.

A key decision in acquisition structuring is whether to acquire shares or assets. In the UK there is no corporate income tax basis for share acquisitions and no relief for goodwill, whereas asset acquisitions may include elements (such as tangible depreciable assets) by which the purchase price will be deductible on an income basis over time. This compares to the US, where an election can be made to treat a share acquisition as an asset acquisition for tax purposes, effectively stepping up the basis in the shares.

Debt push-down

A decision is usually taken centrally on whether to fund an acquisition by debt or equity. The tax shield on interest means that debt is generally preferable, subject to other commercial constraints. Depending on the profits capacity and effective corporate tax rates of the territories where the target is located, it may be tax-efficient to push down this debt to the territories of the target company. The mainstream UK rate is now fairly low at 30%, compared to that of the US and other major European territories.

Relief for interest costs at the level of the local target company will be subject to local tax rules, including the availability of tax consolidation and thin capitalisation (ie, maximum permitted debt/equity ratios) provisions. Typically, to achieve a debt push-down the acquirer will form a holding company in the target's territory which is then funded by debt to acquire the target company. For example, the maximum

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debt/equity ratios in Germany are 9:1 and 3:1 for holding and trading companies, respectively.

Multi-dip financing

Jurisdictions have different bases of taxation, so groups operating cross-border can sometimes take advantage of mismatches in treatment. For example:

- **hybrid entity structures** tax relief for interest costs can be achieved twice (a so-called 'double dip') by structuring, for example, French and German acquisitions through hybrid entities such as a branch or partnership structure; and
- **hybrid instruments** can be used between some territories to achieve equity treatment for the investor and debt treatment for the issuer. Typical instruments include convertibles and profit participating loans.

Clearly, there needs to be sufficient capacity in each territory where the debt is located to be tax-efficient. However, this is also an area in which anti-avoidance provisions are particularly developed, so move forward with care.

Acquisition structuring

Effective acquisition structuring implementing holding, intermediate or offshore finance companies, can help mix low-taxed foreign source income with high-taxed income for more efficient management of foreign tax credits. Structuring holding companies in jurisdictions with a good treaty network is often the key requirement, although these jurisdictions will need continuous monitoring for treaty changes, for example, with the US.

Holding companies are often combined with a finance vehicle, which can be a branch of the holding company or a separate entity. Traditional favoured European locations have included the Netherlands, Luxembourg, Switzerland and the Irish international financial services centre. Some locations income tax on issuance from financing activities at a rate much lower than the mainstream corporate income tax rate.

A key consideration in locating finance companies is the extent of any guarantees that the favourable rates at the time will continue to be permitted as the harmonisation of taxation across the EU proceeds. For example, Irish IFSC companies have EU approval for a 10% tax rate until at least 31 December 2002, but capacity may be a problem.

Minimise transfer taxes

Transfer taxes on acquisitions and disposals can represent a significant cost since they are typically based on the principal amount of the transaction. This may often determine the nature of the acquisition, ie, shares and assets are both often at different rates. Effective planning can often mitigate capital duties, for example, by way of a share for share exchange. Some European territories impose a share issue tax of up to 1%, while share transfer tax can be a significant cost on the transfer of shares in property companies.

Vendor disposal structuring

The nature of the deal may be restricted by the vendor's preference. The level at which the exit takes place can also be critical in determining how much of the vendor's gain is taxable. For example, groups that have intermediate holding companies in overseas locations, such as Luxembourg, will prefer to make the disposal at the level of the holding company, given the ability to use the participation exemption (equity holdings can be disposed of tax-free). The type of vendor can also be an important factor. For example, a number of European territories exempt capital gains from the sale of shares by individuals or the gain is taxable at a reduced rate.

Tax losses

The tax losses of a target company can be a significant attribute for the aquirer.

Some favoured European locations

However, it is often very difficult, due to anti-avoidance provisions for the acquirer, to be able to access those losses at a post-aquisition stage. It may sometimes by possible by means of reorganisation pre-aquisition to facilitate this access.

From the target company's perspective, the ability to use existing capital loans to shelter gains on disposals is of equal importance.

Withholding taxes

Many European territories do not withhold tax from interest paid, the main exceptions being the UK, Belgium, Italy and Spain. There is also no withholding on dividends between EU member states under the parent/subsidiary directive, although a minimum 25% shareholding is required for this to apply as is a minimum holding period.

A basic framework

This article should provide a basic framework for tax strategy in cross-border acquisitions. Clearly, it will be necessary to review the specifics for each transaction and tax advice should be taken before implementation. ■

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