TAX ASPECTS REGARDING THE MERGER AND DIVISION

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Abstract

In this paper, we want to present the tax issues that influencing the merger and division starting from the economic context characterized by a lack of liquidity, business reorganization to streamline the business and from the advantages and disadvantages of this operation achievement. The documentation was performed by consulting the Tax Code, the Methodological Norms regarding the accounting operations of merger, division, liquidation and professional literature.

Keyword: merger, division, tax aspects, merger advantages, division advantages, merger and division disadvantages.

JEL classification: K20, M41

1. Introduction

Evolution of the market and economic environment affect the business, so they pass through various stages of development. So, the growing firms are reorganized, while declining ones restructure or sell unprofitable segments. Often the merger is done by acquiring a company in the same field of activity and division occurs when the firm operates in more sectors and the management team can not only manage all the activities. In the literature, it is said that in a volatile market, the merger is quite active and in a stable market, the divisions and the takeovers rate is quite slow.

Legal framework of these operations is defined in Law no. 31 – Law of the commercial companies, republished in the Official Gazette No. 1066 of 17 November 2004, with subsequent modifications and completions.

Both merger and division have advantages and disadvantages, which we present them in the first part of the paper.

2. Merger advantages

- bring the benefits for strengthening the company's market by obtaining a larger share on the local market or expanding into other geographic regions;
- improve the structure of assets and the sources of funding;
- maintain the business and the personnel in conditions of the competition market and its impact on the company;
- enable the vertical integration of the business, thereby it is shorten the chain between production and distribution;
- help to diversify the product portfolio by launching the own range or buying a player who has already provided that product;
- it has the fiscal advantages compared to the operations of sale and purchase.[1]

3. Division advantages

- determine the reorganization of the company as a group or companies' conglomerate;
- there are eliminated certain products or services that the company provide them, and it can focus on the certain main activities, on the support functions such as accounting, IT, industrial cleaning;

- exit from a regional market and move the resources to other more profitable directions;
- allow using of the certain tax benefits. For example, establishing the headquarters in a country with the tax regime less stringent and conducting the activities in the various other parts of the world.

Finally, we should like to mention the common advantages of the two operations, as: pursuing and achieving the objectives related to the performance indicators, the reduced expenses for the transfer of assets and rearranging of the ownership. [1]

4. Merger and division disadvantages

- for the merger, one of the disadvantages is keeping the management team and of the each department (sales, production, marketing, etc.);
- most times, the contracts for merger/acquisition are built in a long time and involve a strong collaboration of the teams of consultants, lawyers, strategists, etc..
- sometimes, in case of merger, the risk does not get the desired results;
- often, the new company is born under the pressure requirement of immediate success, and this pressure is transferred directly to employees;
- for division, one of the problems is related to the transfer of money from one company to another, which makes it more difficult on other bases than previously. When the company is divided, this transfer should be done through inter-company credit, which involves a long time bureaucracy, etc;
- an impediment that firms are facing both in case of merger and division, is the difficulty to access the bank loans and auctions of the new entities because there isn't a common history and a cumulative turnover.[1]

5. Tax aspects

Tax issues are particularly important and are specified in article 27 of ***Law 571/2003***, published in the Official Gazette. No. 927 of 23 December 2003, with subsequent modifications and completions regarding the Fiscal Code. This article transposes the provisions of Directive 2009/133/EC of the Council of 19 October 2009 regarding the common system of taxation, applicable to mergers, divisions, partial divisions, assignment of assets and the exchanges of shares between the companies of the different Member States and the registered office transfer of an European Company or European Cooperative Societies between the Member States.

5.1 Transfer of assets

The merger or division operations *are not taxable transfers* for the difference between the market price of the transferred assets and liabilities and their values for tax purposes. For the transaction to be treated as a tax free transfer, the recipient company must calculate depreciation and any gain or loss related to the transferred assets and liabilities, in accordance with the provisions which would have been applied to the transferring company if the merger, division or partial division had not taken place. In addition, the being acquired company will send to the acquiring company the tax value corresponding to each transferred asset or liability.

In order to determine the exchange ratio it should be performed the assessment of the companies' assets. For this situation, the current legislation is quite unclear, causing many debates on the accounting records which must be performed during the evaluation. Thus, according to the provisions of Order no. 3055/2009, the evaluations performed during reorganizations are not considered revaluation in the accounting sense; they are executed strictly in order to determine the exchange ratio for all items in the balance sheet. In this context, the evaluation results will not be recorded in the financial statements (for example in the reserve accounts of the revaluation). There is an exception when the date of the financial statements that underlie the reorganization coincides with the date of the annual financial statements.

However, in concordance with the practical examples of calculation of the merger scenarios presented in the Methodological Norms for the application of Order no. 1376/2004 the assessments will be recorded in the accounting in case of the acquiring company (on account of revaluation reserves) and for the being acquired company will not be included in the financial statements prepared on the merger, any positive difference resulted between the actual net contribution (which includes the assessment result) and the intake sheet recorded after the merger as "goodwill", which is not a depreciable asset from a fiscal perspective. However, in practice, on considering the lack of the supplementary

classification of this theme, the approaching is very varied in case of the evaluations performed during the mergers and differ function of accounted and chosen interpretation.

A possible solution to this problem, which can lead to avoid of some complications in terms of accounting and tax, is the merger realised on the date and based on the financial statements. Although this potential solution brings the tax benefit, it seems that, in practice, often, the strategic planning conducted by the shareholders, on which the merger is implemented, is performed by taking into account the foresee indicators, through the reporting to other periods than the date on which annual financial statements are prepared.

5.2 Provisions and reserves

Reduction or cancellation of any provision or of a previously deducted reserve in the income tax calculation will assimilate to the taxable income.

When the constituted provisions or reserves were previously deducted from the tax base by the transferring company and are not derived from permanent establishments abroad may be taken under the same conditions to deduct by the permanent headquarters of the beneficiaries society located in Romania, the receiving company thereby assuming the rights and obligations of the transferring company.

In the actually conditions of the market, that are marked by the lack of liquidity and significant accounting losses, the taking of the reserves - especially those related to the certain tax facilities that were previously acquired by the company or the reserves representing the surplus realised from the revaluation reserves of the fixed assets made after 1 January 2004 existed in the 1065 account balance on 30 April 2009 - can be difficult to realise.

In practice, such the situations are encountered especially if there is a negative net contribution of the acquired company, caused by the large accounting loss that exceeds the value of other items included in the proper capital of that company or if the first fusion is not sufficient to cover the value of all stocks (in this case, the tax will be realised only on the part of the reserves uncovered by the first fusion). So, after the merger, if these reserves aren't taking, they will be subject to taxation, attracting additional obligations in terms of the income tax.

Another problem that can arise in case of a net negative contribution refers to decreasing the proper capital to a value less than half the amount of the subscribed capital. In this case, the extraordinary general meeting of the shareholders shall be convened to decide to dissolve the company or to find a solution to fix this problem. Considering the fact that the current legislation on this issue is quite complex, when there is in practice such a similar situation, solving of this problem and all the implications that may appear must be realised under the guidance of the specialists.

In addition to the above, an increased attention should be taken if the acquiring company holds majority share of securities in the company being acquired. For this situation, the acquiring company is in situation to remunerate the owned shares for the net contribution of the acquired company. So, the total number of the shares to issue after the merger for the shareholders of the acquired company, based on the exchange ratio, will decrease with the proportion that already owned by the acquiring company. In such cases, when there is a majority ownership, the merger will be achieved without a significant additional increasing of the social capital (this can also have null value when the holding is 100%) and decreasing the amount of the merger (0 when the holding is 100%). Consequently, the previously reserves deducted at the calculation of the income tax, which cannot be taken, will be subject to taxation.

It should be noted that in this situation there is a tax advantage. In case of cancellation of shares to persons holding at least 15%, respectively and 10%, since 2009, the share capital of another Romanian legal person that transfers the assets and liabilities in a merger, the transfer does not constitute a transfer taxable.

In the case of the legal reserve, after the merger, its recorded value by the acquiring company exceeds one fifth of the social capital of the company, the difference will not be treated as the taxable income as long as the reserve is maintained at the resulted value.

5.3 Deductibility of the expenses with interests

In these economic conditions, lack of liquidity can determine the situation when many companies resort to the loans taken from the mother-companies or from other entities. To determine the rules of the applied deductibility in calculating the income tax, the interest on these loans will be subject to the limitations in the article 23 of the Tax Code. So, initially, it will be compared with the statutory rates of deductibility set by law (the reference interest of the National Bank of Romania for the last month of the quarter, for loans in lei and 6%, respectively for loans in foreign currency), the exceeded values of these thresholds are permanent considered not deductible in terms of income tax. Then, the expenses with net interests and losses from the exchange differences will be deductible as long as the indebtedness of the capital is less or equal to three, and the own capital is positive. Otherwise, the company has the possibility of

carrying forward these expenses in the subsequent tax periods until the achieving the above set conditions and getting full deductibility.

During the merger, when the companies involved have a negative capital (net accounting assets) caused by any accounting losses, there is a risk of the existence of limitations that refers at the deductibility of the expenses related to such loans. In addition, in this case, due to lack of the premium merger, after the merger, from an accounting perspective, the acquiring company will take the debit of account 117 (the reported result), negative account net assets of the company being acquired, thus reducing value of the own capital held by the acquiring company. Thus, following the merger, it can reach a deterioration of the own capital in the acquiring company. In this way, at the level of this society, the indebtedness may increase exceeded the threshold of three or the own capital can become negative, causing further problems for the deductibility of the interest expenses and the net losses from the difference of the currency exchange.

In this case it can be resorted at one of the following solutions: converting the borrowings from the shareholders in the share capital by issuing additional shares to increase the social capital, cancellation of the debt on loans (solution particularly applicable if there are registration of the tax losses because the described operation would generate taxable income which could cover losses previously recorded) or a combination of those shown, according to the current effective situation in the society. Optimal solution must be achieved taking into account by all the fiscal and commercial consequences resulting from the implementation of an alternative or another.

5.4 Rules on exchange of shares

a) Assigning, in case of the merger, division, exchange of shares of the participation titles representing the capital of the receiving or acquiring a participant of the transferring or acquired company in exchange for securities representing the capital of that company and not the taxable transfers in terms of the profit tax and the income tax.

Condition to be considered not taxable transfers, is the shareholder not to assign to the received participation titles a higher tax value than the tax which they had before the merger, division or exchange of shares.

b) Assignment, in case of partial merger, division, of the shares of the transferring company representing the capital of the beneficiary company, it represents the taxable transfers.

Condition to be considered not taxable transfers is the shareholder, not to assign to the received participation titles and those held in the transferring company a fiscal value higher than the value of the securities held in the transferring company before the partial division.

c) Profit or income, from the subsequent transfer of the shares, is taxed with the income tax or the profit tax according to the person holding the titles.

There are taxable transfers, for the difference between the market price of the assets and liabilities transferred and their tax values, the operations of merger, division, partial division, transfer of assets or exchange of shares, which:

a) has as its principal objective or as one of the principal objectives the fraud and tax evasion.

b) have the effect that a company involved or not in operation, no longer fulfils the conditions required for the representation of employees in the management of the company in accordance with the agreements in force before to that operation. This provision is applied when the companies that referred in this article does not apply the community law provisions containing equivalent norms on representation of employees in the management of the company.

The fiscal value is the value that is used to calculate incomes or losses, to determine the taxable income or the capital contribution of a participant of the society.

Where the assets and liabilities of the transferring company in Romania are transferred to a fusion operation, division, partial division or transfer of assets include the assets and liabilities of a permanent establishment situated in another Member State, including in the Member State in which it is resident the beneficiary company, the right to tax the permanent establishment is responsibility of the Member State where the beneficiary company is located.

5.4 Recovery of the tax loss

Tax loss is the amount recorded in the tax return year.

In accordance with the provisions of article 26 of Law 571/2003 regarding the Fiscal Code with subsequent amendments and completions, the recovery of the tax loss determined by tax declaration, as a rule, is realised from the taxable profits made in the following 7 years consecutive.

In case of mergers in terms of the tax loss, we have the following situations:

- taxpayers which ceases to exist as a result of mergers or divisions, when they recovery of the tax loss recorded by them is done as follows:
  - by business start-ups;
  - by the firms which take over patrimony of the acquired company or divided.

The modality to take over the tax is proportional to the assets and liabilities transferred to the businesses, according to the project of merger or division.

- taxpayers who do not cease to exist as a result of operations of detachment of part of their property, transferred as a whole, in which case recovery of the recorded tax loss by them is done as follows:
  - by the taxpayers who do not cease to exist (the transferor company);
  - by the companies that take a part of the patrimony of the transferring company

The modality to takeover the tax loss is proportional to assets and liabilities transferred to the legal beneficiary entities in accordance with the project of division, namely in relation to assets and liabilities held by the transferring legal entity.

Procedures of recovery for the tax losses

Recovery of the annual tax losses is made in the order of their registration at the each time of payment of the income tax, according to the legal provisions in force since the year of their registration.

When the accounting loss recovery is done by the legal reserves, constituted from the profit before tax, the subsequent reconstitution of the legal reserve will not be a deductible amount in calculating the taxable profits.

Annual tax losses from previous years of operations of mergers, division or removal of the part of its patrimony, not recovered by the transferor taxpayer, and sent to the beneficiary taxpayer, it is recovered at the each time of payment of the income tax following the date on which these operations produce effects, according to the law, on the remaining recovery period of 5 and 7 years, in the order they were recorded by the transferor taxpayer.

Tax losses recorded by the transferor taxpayer during the current year between 1 January and the date on which the transaction produce effects, sent to the beneficiary taxpayer are recovered at each period of income tax payment that following the date on which such operations take effect, according to the law. This loss is taken into account by the beneficiary taxpayer, in determining the taxable income / tax loss in that fiscal year, before to recovery the tax losses from previous years.

In order to recover the tax losses transferred or retained, where appropriate, the transferor taxpayer and the beneficiary taxpayer performs the following operations:

a) the transferor taxpayer calculates the tax loss for the period between January 1 and the date of operation of detachment of a part of the patrimony produces effects in determining the part of the loss submitted to the beneficiary taxpayer, respectively to the part that continues to recover, in proportion with the assets and liabilities transferred/ maintained;

b) the transferor taxpayer highlights the part of the tax loss in the current year and from the previous years transferred/ maintained in the register of the tax;

c) the transferor taxpayer submits to the beneficiary taxpayer a document that must contain the tax information regarding:

- Annual tax losses transferred to the beneficiary taxpayer, recorded in its income tax statements, including the year in which the operation of the reorganization takes effect, detailed on each fiscal year;

- In case of operations for detachment of a part of the patrimony, there is transmitted and the part of the tax loss recorded in the current year, determined by adjusting the tax loss calculated at letter a) and the tax losses from previous years, in proportion to the assets and liabilities submitted to the beneficiary taxpayer according to the project of division;

d) the beneficiary taxpayer records in the register of tax, the tax losses taken on the basis of the document submitted by the transferor taxpayer, which distinct highlights the recovery period for each transferred tax loss.

If the taxpayer, starting from February 1, 2013, applies the system of taxation on the enterprises' income and respects the recovery rules of the tax loss:

- the tax losses recorded in the previous years of 2013 is recovered according to Art. 26 of the Tax Code, from the date on which the taxpayer returns to the payment system of the income tax in the year 2013 is considered one fiscal year for the purposes of the 5 or 7 consecutive years;

- tax loss for the period 1 January to 31 January 2013 inclusive, registered by a taxpayer in that period was paying the income tax, is recovered, according to Art. 26 of the Tax Code, from the date on which the taxpayer returns to the payment system of income tax, and 2014 is the first year of recovery of the tax loss, meaning the 7 consecutive years;

- if the taxpayer returns during 2013, at the system of payment of the income tax according to art. 112 ^ 6 of the Tax Code, the tax loss recorded in the period 1 January to 31 January 2013 inclusive is taken into account in determining the income taxable/tax loss for the period 1 February to 31 December 2013, before recovering the tax losses from previous years of 2013 and recovered according to article 26 of the Tax Code since 2014, to the limits of 7 consecutive years. Period 1 February to 31 December 2013 is not considered the fiscal year for the purposes of the 7 consecutive years.

6. Conclusions

From the above presented, there are resulted the following conclusions:

- the twos operations have advantages and disadvantages, so the decision is a strategic one and must take into account of each of them;
- merger or division operations are not taxable transfers for the difference between the market price of the transferred assets and liabilities and their tax values;
- reduction or cancellation of any provision or a reserve previously deducted in the calculation of the income tax will absorb the taxable income;
- assigning, in case of the merger, division, exchange of shares of the participation titles representing the capital of the one participant from the recipient company, in exchange for some securities representing the capital of that company and not the taxable transfers in terms of the profit tax and the income tax;
- the merger may increase indebtedness to an amount bigger than three, which leads to the non-deductibility of the interest expenses and of the net losses from the differences of the currency exchange;
- annual recovery of the tax losses is made in order of their registration at the time of each payment term of income tax, according to the legal provisions in force, since their registration.

References:

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[3] Law no. 571/2003 *regarding the Fiscal Code*. Published in the Official Gazette. No. 927 of 23 December 2003, with subsequent modifications and completions.

[4] Law no. 31/1990 *of the commercial companies.* Republished in the Official Gazette No. 1066 of 17 November 2004, with subsequent modifications and completions.

[5] Order of Ministry of Finance no. 1376/2004 *for approval the Methodological Norms regarding the reflection in the accounting of the major merger, division, dissolution and liquidation of the commercial companies,* and withdrawal or exclusion of some shareholders of the companies and their tax treatment, published in the Official Gazette No. 1012 of 03.11.2004