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Deconsolidation tax issues in acquisitions

In our M&A practice, tax considerations play an important role. Aside from due diligence and the structuring of the acquisition, the tax provisions in the purchase agreement are of significant importance. In the Dutch M&A practice, typically a subsidiary is removed from a larger fiscal unity for Dutch corporate income tax ("CIT") purposes. This gives rise to specific tax issues that require careful consideration by both the purchaser and the seller. This newsletter summarizes the 10 most important issues.

1. The deconsolidated subsidiary has no CIT history; its tax history remains with the seller.

A fiscal unity constitutes a fiscal consolidation, pursuant to which a group of companies is taxed as a single entity (namely, at the level of the parent company) for CIT purposes. The consolidated subsidiary can no longer be taxed for its results in the period in which it forms part of the fiscal unity.[i] At the moment the subsidiary leaves the fiscal unity, due to the fact that the interest in the subsidiary is transferred to the purchaser, it becomes liable to tax again. So the purchaser enjoys a subsidiary without a tax history, ie without potential unforeseen CIT liabilities. The only history there could be as regards to CIT is the pre-fiscal unity period. The seller should realise that the CIT history of the subsidiary will remain with the parent of the fiscal unity after deconsolidation.

2. In the interest of the purchaser, tax sharing arrangements are terminated at the time of sale and the purchaser should wish to be protected against any liabilities arising from tax sharing arrangements.

The individual financial statements of the subsidiary should not show any CIT liability, since it is not liable to CIT. This would suggest that the subsidiary is somehow exempt from tax, even though the profits are effectively taxed but at the level of the parent company. For this reason, the Annual Reporting Guidelines (*Richtlijnen voor de jaarverslaggeving*) prescribe that CIT could be accounted for in the individual financial statements of the subsidiary. As there is no statutory obligation for the parent company to charge the tax to the subsidiary, the tax liability as reflected in the balance sheet of the subsidiary is based on an agreement, ie a tax sharing arrangement. In our experience however, that agreement is seldom put in writing.[ii]

The purchaser clearly wishes to be released from any liability under such an agreement, if for no other reason that the terms are not put into writing. The seller could argue that with the sale of an independent taxable entity come the unforeseen tax risks from its history. This should not be any different for a subsidiary that is removed from a fiscal unity, which entered into an agreement simulating an individual liability to tax. In practice however, the seller realizes that the purchaser cannot agree without there being a detailed tax sharing arrangement in writing. Furthermore, it is common practice that the purchaser will ask (and receive) protection for all unprovided tax liabilities. To simulate a tax history for CIT, to then subsequently give protection for unprovided CIT liabilities resulting from said tax history seems too arduous for the seller; that is why, in our experience, this occurs very rarely. The agreement will, in the interest of the buyer, stipulate that there are no tax sharing arrangements in force at the moment of the sale.

Because payments under a tax sharing arrangement do not constitute a tax levied by law, but rather compensation under an agreement, the protection for unprovided tax liabilities in the agreement will not apply to these payments. This is why liabilities under a tax sharing arrangement are brought under the scope of the tax indemnity.

3. The CIT liability in the balance sheet of the subsidiary leaving the fiscal unity must be set off against the purchase price.

Typically, with the sale of an independent taxable entity, the purchase price will be reduced with the amount of any current tax liability of that entity. The same can happen with a subsidiary in a fiscal unity; presumably because the people involved in the transaction are not familiar with the concept of a fiscal unity. Any CIT liability of a subsidiary in a fiscal unity is no liability to the tax authorities. Rather, it concerns a liability to the parent company, which behaves as a current account with the parent company. Therefore, the purchase price may well be reduced, but the liability must also be paid on the day of the transfer. Or, even better: the purchase price is not lowered and the receivable is acquired by the purchaser.

4. The seller will want to be reimbursed for the tax due by the parent of the fiscal unity over the profits of the subsidiary after the Effective Date. The purchaser will want to be reimbursed for losses in that period.

In a given transaction, parties often agree that the profits of the target company will, for example from the beginning of the financial year (ie the Effective Date), belong to the purchaser. The purchase price will be determined on the basis of the available and audited financial statements of the start of the financial year, adjusted for the profits minus taxes from the Effective Date until the date of the transfer of shares. Due to the fiscal unity, the profits from the Effective Date onward would indeed be for the subsidiary and purchaser, but, the CIT liability would remain with the parent of the fiscal unity. Obviously, that is not in the best interest of the seller. The seller will therefore want to be reimbursed for the amount equal to the CIT relating to the taxable profits over the relevant period. This will have to be dealt with in the purchase agreement. In the event that there are losses, the purchaser will want to be reimbursed, as the losses will remain with the seller. Those losses can under certain circumstances be surrendered to the subsidiary. The issue will then be somewhat more complicated to deal with adequately.

5. The purchaser will want to avoid surprises regarding the subsidiary's opening balance sheet for tax purposes.

During negotiations, the purchaser will confront the seller with all kinds of arguments that would result in a lower purchase price. In one transaction, we represented a seller who was told by the purchaser that the pension scheme of the target company was underfunded. Parties then agreed to split the price difference without having regard for the tax consequences. As a result, the seller enjoyed the tax benefit of the higher pension provision as the parent of the fiscal unity, which translates into a higher pension provision in the opening balance sheet for tax purposes of the subsidiary. In short, the seller had enjoyed the tax benefit of the increase in the provision. The purchaser will therefore want to include a procedure in the agreement that will guard against these types of actions by the seller. As a side note, the subsequent proceedings brought by the purchaser were decided in favor of the seller.

On a related note, the seller will have to deal with an audit by the tax authorities as regards the history of the fiscal unity. In this situation, the purchaser will have an interest in being involved, as the outcome of such an audit can have consequences for the future tax position. The purchase agreement will have to contain specific arrangements regarding this subject.

6. Both purchaser and seller have an interest in preventing a premature independent tax liability of the subsidiary.

The moment the subsidiary leaves the fiscal unity will coincide with the moment that the parent will no longer have the legal and economic ownership of 95% of the shares in the subsidiary. This will, at the earliest, be the moment of signing the agreement and at the latest the moment of the transfer of shares. In any event, this will not be the Effective Date, as the parent will still have had the beneficial and legal ownership of the shares at that moment in time. The exact date of the subsidiary leaving the fiscal unity is not up to the parties to decide, but is determined by law. Any agreement fixing this date is not relevant in that sense, as the tax inspector is likely to have his own views regarding the subject. Parties can of course agree on what they will take to be the date at which the subsidiary leaves the fiscal unity, and act accordingly. Often, the goal will be to have this date coincide with the moment of the transfer of shares. As this is the date on which the purchaser can form a fiscal unity with the target company, no interim independent tax liability will exist for the subsidiary (and any subsidiaries). Often, the tax inspector will follow the date agreed by the parties, notwithstanding the law and case law that seem to point towards the earlier moment of signing for the moment at which the subsidiary leaves the fiscal unity (or the date on which the conditions precedent have been met). At that moment in time, the seller has agreed to transfer the shares, which means that the seller will no longer have the economic ownership of 95% of the shares.

The Fiscal Unity Decree 2003 (*Besluit fiscale eenheid 2003*) provides for the possibility of forming a fiscal unity on the date of signing the agreement, if the intention is that the transfer of the legal ownership of the shares will follow promptly (and in any event within five business days). It can be requested that this period of five business days is extended to a maximum of three months, if the transfer of legal ownership is dependent on a circumstance outside the control of the purchaser and seller. Often, more than five business days are needed to execute the transfer of the shares, and as such, a request would be required. In practice, such a request is rarely made, as it is not expected that the request will be dealt with in a timely manner, a difference of opinion arises whether a circumstance falls outside of the control of purchaser and seller, the transfer ends op taking longer than three months, and, often enough, because the tax inspector uses the date of transfer as the date for both the deconsolidation as the date of joining the new fiscal unity.

7. The purchaser has an interest in making sure the transfer of tax losses is properly taken care of and to claim compensation insofar less tax losses are transferred than previously agreed upon.

As was previously mentioned, the subsidiary leaves the fiscal unity without a CIT history, which means there are no tax losses available to the subsidiary apart from the tax losses incurred during the pre-fiscal unity period. The tax history (including the tax losses) stays with the parent of the fiscal unity, unless the parent and the subsidiary jointly request to surrender those tax losses that are demonstrably tax losses of the subsidiary (Article 15af of the Dutch Corporate Income Tax Act of 1969, "CITA"). This matter will have to be dealt with in the agreement. The same goes for the question of what will happen if less tax losses are surrendered than previously agreed upon. Generally, the seller will not be willing to compensate the purchaser 25% (the CIT rate) for each euro of tax not surrendered.

Article 15af CITA only applies to all tax losses up and until the moment of deconsolidation. That moment will, as a rule, be after the Effective Date. In that case, the losses to be surrendered will be those before and after the Effective Date. The losses after the Effective Date are for the purchaser, and should not be compensated for.

8. The purchaser will want to be indemnified for joint and several liability as a result of the failure of the parent company to pay CIT.

In the event the parent company of the fiscal unity fails to pay the CIT due over a certain period, the tax collector may hold liable any subsidiary that was or is a part of the fiscal unity for the tax liability (Article 39 of the Collection of State Taxes Act 1990, "CSTA"). The purchaser will want to guard itself against such a possibility, and as a rule, the seller will be willing to provide an indemnification. A seller that would refuse to give such an indemnification would essentially put the risk of its own failure to pay with the subsidiary that no longer forms part of the fiscal unity. This is a tough sell. The purchaser that is protected against potential tax liability from the past is not automatically protected against an Article 39 CSTA-claim due to the slightly different nature of the claim. As such, this matter has to be dealt with separately in the agreement. In case of failure to pay by the parent company, little is to be expected of the indemnification; if the parent company is also the seller, there will most likely not be any available resources to pay the purchaser.

9. Both the buyer and the seller will want to be indemnified for the set off of the respective tax receivables with tax liabilities of the respective other.

Amounts payable and amounts due in respect of taxes can be set off by the tax collector. The possibility to set off these amounts has been expanded to the amounts payable and amounts due in respect of all the members of a given fiscal unity. Therefore, a tax liability of a subsidiary that has left the fiscal unity from the period of time in which it still belonged to that fiscal unity can be set off with a tax receivable of – eg – the parent company. Unfortunately for the subsidiary, the reverse is equally possible. Both parties therefore have an interest in dealing with this matter adequately by indemnifying each other.

10. The seller will want to be compensated for taxable revaluations (such as, eg, the revaluation ex Article 15ai CITA) where such a revaluation gives rise to a tax benefit (ie an amortization benefit) at the level of the deconsolidated subsidiary.

The deconsolidation can result in a taxable revaluation for assets that have been shifted within the fiscal unity (Article 15ai CITA). The tax is levied from the parent company, whilst the deconsolidated subsidiary enjoys the benefit of the higher depreciation base. It is therefore in the interest of the seller to be compensated for this, but also for other revaluations that show similar features. The purchaser will typically not want to compensate more than the discounted value of the future benefit and will possibly only want to pay if and when the benefit is received by the purchaser. Under certain conditions[iii], this revaluation claim can be transferred. This will require the cooperation of both the parent company as well as the subsidiary, which is why it should be adequately dealt with in the agreement. The question is whether the purchaser will be willing to cooperate with the transfer of the claim. This would restrict the freedom of movement for the buying group of companies and the risk of the taxable revaluation would be transferred to the buyer. This risk will be somewhat offset by the savings that come from the depreciation benefits, but all in all it's still not very appealing. On the other hand, the transfer will be worth something to the seller. It stands to reason that the purchaser may be willing to give up some of its freedom of movement if the seller is willing to compensate a potential tax reduced by the net present value of the future benefit.

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[i] For the avoidance of doubt: it is not the case that the parent pays on behalf of the subsidiary. See, for this misunderstanding, the Dutch Supreme Court (*Hoge Raad*) decision in Pontmeyer of 19 January 2007, NJ 2007/575.

[ii] The agreement will seldom go so far as to completely simulate an individual liability to pay tax for the subsidiary. The taxes will eg be attributed based on the financial statements without a set off when submitting the tax return or making adjustments. The latter would cost time and money without any clear purpose.

[iii] Order of 14 December 2010, nr. DGB 2010/4620M.

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