

Master in Finance

Accounting and Tax - Mergers and Acquisitions Operations

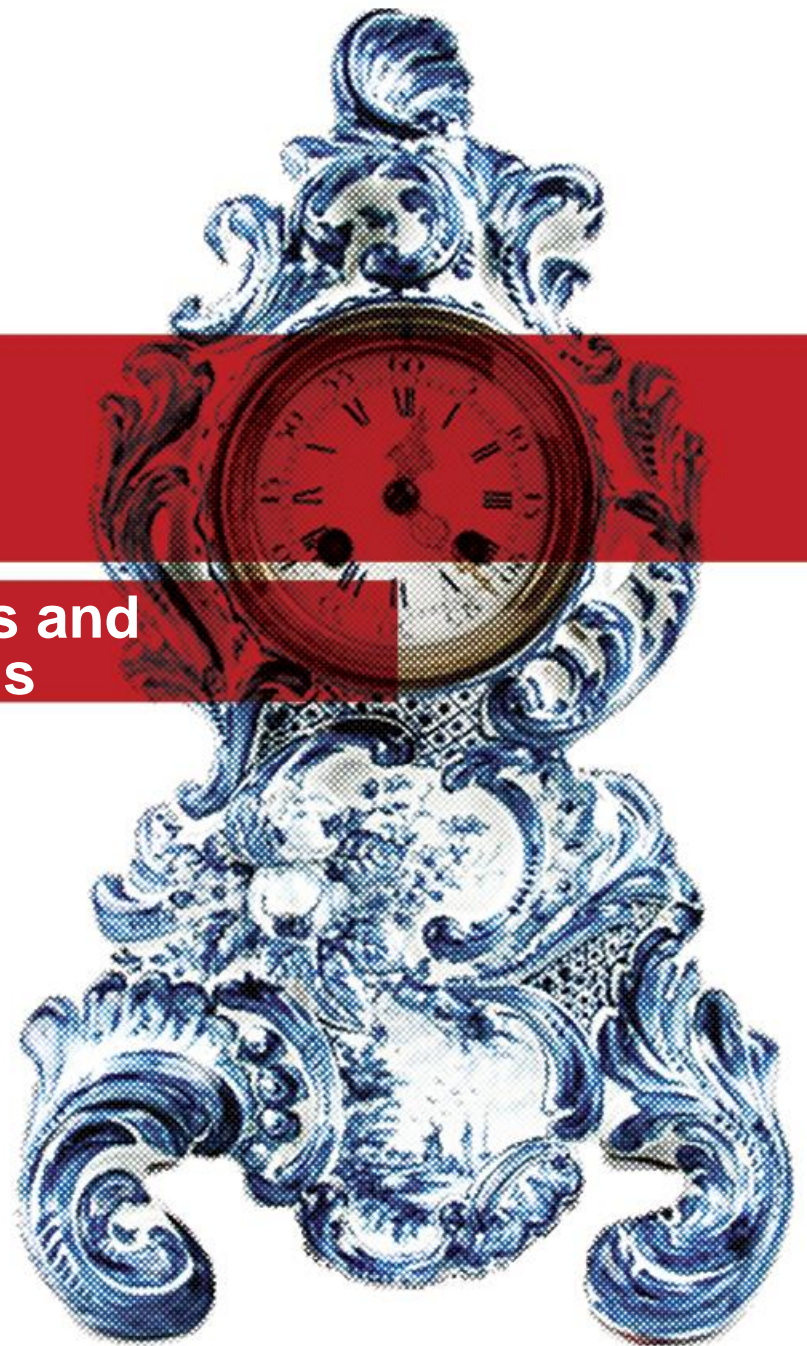
2015



Instituto Superior de Economia e Gestão
UNIVERSIDADE TÉCNICA DE LISBOA

DESDE 1911

100 ANOS A PENSAR NO FUTURO

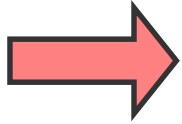


Accounting and taxation aspects inherent to Business Combinations



- Applicable regulation;
- Identifying a business combination;
- Accounting method;
- Acquisition method application;
- Goodwill;
- Review (2009) and summary of IFRS 3 and other regulatory references.

Merger Process: Accounting Aspects



APPLICABLE REGULATION



Applicable regulation

□ Accounting regulation:

- IFRS 3 – Business Combinations (replace NIC/IAS 22).
- FAS 141 – Accounting treatment of business combinations.

□ Purpose and Scope:

- [IFRS 3] The objective of this IFRS is to improve the relevance, reliability, and comparability of an entity's financial statements with respect to the information provided about business combinations and their effects. IFRS 3 establishes principles and requirements regarding recognition and measurement of identifiable assets and goodwill acquired, liabilities assumed, any non-controlling interest in the acquire, and any gains from a bargain purchase.



Applicable regulation

□ **Purpose and Scope:**

- In particular, IFRS 3 – that appears in March 31, 2004 – specifies that all business combinations must be accounted using the method of acquisition.

- However this IFRS shall not apply to:
 - a) Business combinations in which separate business entities or combine to form a joint venture;
 - b) Business combinations between entities or businesses under common control;
 - c) On Business Combinations involving two or more mutual status;

Merger Process: Accounting Aspects



Applicable regulation

□ Purpose and Scope:

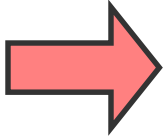
- However this IFRS shall not apply to:
 - d) Business combinations in which, through a contract, separate entities or businesses are combined to form only a reporting entity, but without obtaining any ownership (for example, combinations in which separate entities are combined by midst of a contract to build a society with two securities traded).

Merger Process: Accounting Aspects



4) Analysis of the Financing options

APPLICABLE REGULATION



IDENTIFYING A BUSINESS COMBINATION



Identifying a Business Combination

□ **[IFRS3.4] What is a Business Combination?**

- A business combination is defined in IFRS 3 as “a transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as ‘true mergers’ or ‘mergers of equals’ are also business combinations as that term is used in this IFRS.”

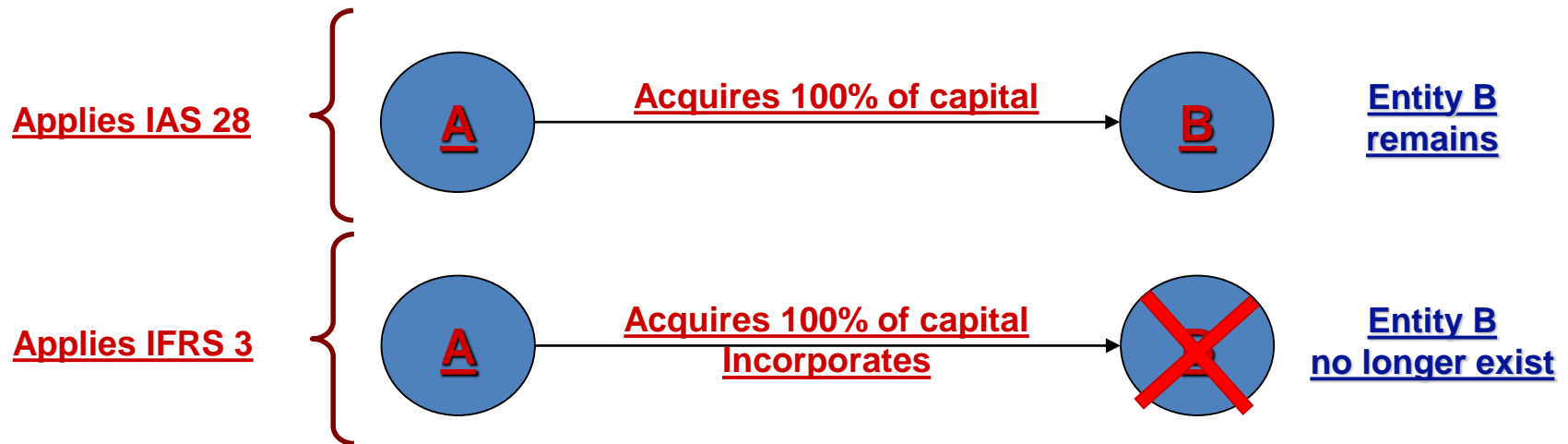
□ **Business definition**

- A business can be seen as “an integrated set of activities and assets that is capable of being conducted and managed” to provide a return to investors – or other owners, members or participants – by way of dividends, lower costs or other economic benefits.

Identifying a Business Combination

□ Consequences

- In what concerns to financial reports and reporting purposes after a merger remains only one company.
- It differs from investments in associated companies, where there are still two (or more) entities.



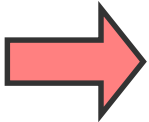
Merger Process: Accounting Aspects



APPLICABLE REGULATION

IDENTIFYING A BUSINESS COMBINATION

METHOD OF ACCOUNTING





Method of accounting

- **Acquisition Method** [IFRS 3.14] All business combinations are accounted for using the method of acquisition.
 - It differs from investments in associated companies, where there are still two (or more) entities.

- **How to apply this method?**
 - [IFRS 3.15] The method provides for the purchase business combination from the perspective of the merged entity that is identified as acquiring institution. The buyer will purchase the net assets and recognize the assets acquired liabilities and contingent liabilities assumed, including those previously unrecognized by the acquired entity.

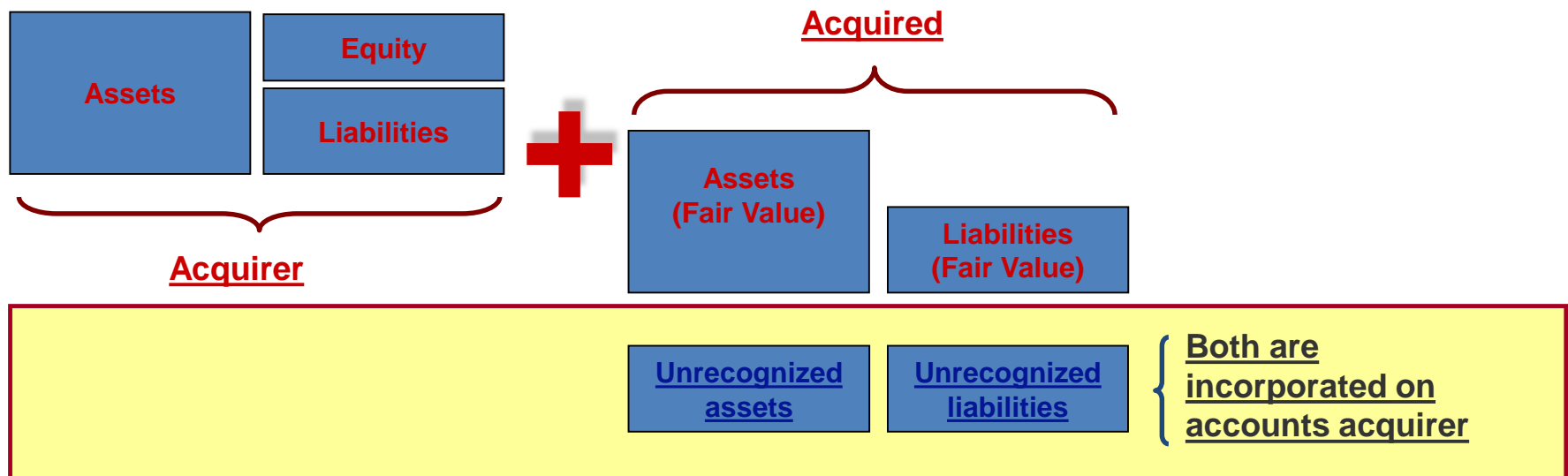
Merger Process: Accounting Aspects



Method of accounting

□ How to apply this method?

- [IFRS 3.15] The valuation of assets and liabilities of the acquirer will not be affected by the transaction, nor does it recognize additional assets or liabilities of the purchaser as a result of the transaction, since they are not subjects on which it rests.



Merger Process: Accounting Aspects

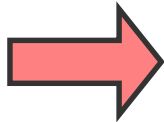


APPLICABLE REGULATION

IDENTIFYING A BUSINESS COMBINATION

METHOD OF ACCOUNTING

APPLICATION OF THE ACQUISITION METHOD





Application of the acquisition method

□ [IFRS 3.16] Steps to follow:

- 1) identification of the acquiring institution;
- 2) valuation of the cost of the business combination;
- 3) distribution, on the date of acquisition, the cost of business combination between the assets acquired and liabilities assumed and contingent liabilities.

+

goodwill



Application of the acquisition method

□ Identifying the acquirer

- The purchaser is the combined entity that obtains control of other businesses or entities involved in the mix. The relationship between the combining entities determines which entity obtains control, i.e.:
 - Under IFRSs, which entity has power to govern the financial and operating policies of the other entity so as to obtain benefits from its activities; or
 - Under U.S. GAAP, which entity has controlling financial interest over the other.



Application of the acquisition method

□ Identifying the acquirer

□ [IFRS 3.20] Although at times it can be difficult to identify an entity acquiring, generally there are indications that reveal its existence. Some clues are:

1. if the fair value of one of the combined entities is significantly greater than that of the other combined entity, it is likely that the purchaser is the largest fair value;
2. if the business combination is effected through a regular exchange of instruments of heritage with voting rights, for cash or other assets, it is likely that the purchaser is an entity that delivers cash or other assets;
3. if the business combination would result in the direction of one of the combined entities will be able to control the selection of the management team of the combined entity resulting, it is likely that the entity whose address is capable of exercising this control is the purchaser.



Application of the acquisition method

□ **Cost of Business Combination**

- [IFRS 3.24] The acquiring institution will assess the cost of business combination as the sum of:
 - a. fair values at the date of exchange of assets handed over, liabilities incurred or assumed and equity instruments issued by the purchaser in exchange for control of the entity acquired; more
 - b. any costs directly attributable to the business combination.

Merger Process: Accounting Aspects



Application of the method of purchase:

□ Imputation, on the date of acquisition, the cost of the combination to the assets acquired and liabilities and contingent liabilities assumed.

□ The acquirer must allocate the cost of the merger, to proceed to the recognition of assets, liabilities and contingent liabilities of the acquired party, the criterion of fair value;

The only exception relates to non-current assets (disposal groups called), that are classified as held for sale, as required by IAS 8.

Merger Process: Accounting Aspects



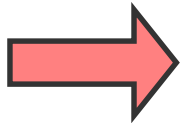
APPLICABLE REGULATION

IDENTIFYING A BUSINESS COMBINATION

METHOD OF ACCOUNTING

APPLICATION OF THE ACQUISITION METHOD

GOODWILL





Goodwill

□ Definition of goodwill

- Goodwill is an accounting concept inherent to business combinations and is measured as the difference between (a) and (b) with:
 - a) The sum of:
 - The fair value of the consideration transferred;
 - The recognized amount of any non-controlling interest in the acquire; and
 - For a business combination achieved in stages, the fair value of any previously held equity interest in the acquiree.
 - b) The recognized amount (generally fair value) of the identifiable assets acquired and liabilities assumed



Goodwill

□ Definition of goodwill

- [IRFS 3.52] Goodwill can also be defined as a payment made by the purchaser as a foretaste of future economic benefits of the assets which could not be identified and recognized separately.
- If for some reason the price paid by the acquirer to obtain the control over the other entity is lower than the sum of the fair values of assets and liabilities the goodwill appears as a negative goodwill (badwill)



Goodwill

□ Measurement and recognition

- [IRFS 3.51] Initially goodwill is assessed by its cost, being the excess cost of the business combination on the participation of the acquirer in the fair value of net assets, liabilities and contingent liabilities identifiable of the acquired company.
 - If the difference is positive, the result is a **positive goodwill** and the recognition is given as another **asset**.
 - If the difference is negative, the result is a **negative goodwill** and the recognition of this is given as a **profit of the period**.

This way, the goodwill is measured as the residual cost of the business combination, after recognizing the assets, liabilities and contingent liabilities of the acquired entity (IFRS 3, p.53)

Goodwill

□ Accounting treatment of Goodwill

- When the acquirer company proceed to the recognition of the identifiable assets, liabilities, and contingent liabilities, should also proceed to the recognition of goodwill.
- Following [IFRS 3.55] Goodwill can not be amortized. Instead, the acquiring institution will analyze the deteriorating value annually or more frequently if events or changes in circumstances indicate that its value could suffer deterioration in accordance with IAS 36 Impairment of Assets.



- This fact contributes to increase the result's volatility.

Merger Process: Accounting Aspects



APPLICABLE REGULATION

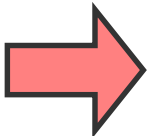
IDENTIFYING A BUSINESS COMBINATION

METHOD OF ACCOUNTING

APPLICATION OF THE ACQUISITION METHOD

GOODWILL

**BUSINESS COMBINATION BY PHASES AND OTHER
REGULATORY REFERENCES**





Business Combinations by phases

- [IFRS 3.58] Example of a business combination by phases: successive purchases of actions. When this happens, each exchange transaction will be treated as separate transactions by the acquiring institution, using information on the cost of the transaction and the fair value at the date of each exchange to determine the amount of any goodwill associated with the transaction.

- [IFRS 3.59] “Where a business combination transaction involving more than one exchange, the fair value of assets, liabilities and contingent liabilities acquired identifiable entity may differ on the dates of each transaction exchange. Because of that:
 - a) The assets, liabilities and contingent liabilities acquired identifiable entity was restated as the fair value at the date of each transaction exchange, in order to determine the amount of goodwill associated with each transaction;



Business Combinations by phases

- [IFRS 3.59] Where a business combination transaction involving more than one exchange, the fair value of assets, liabilities and contingent liabilities acquired identifiable entity may differ on the dates of each transaction exchange. Because of that:
 - b) Assets, liabilities and contingent liabilities of acquired identifiable must be recognized by the acquiring institution by their fair values at the date of acquisition, any adjustments to such fair value related to the involvement of the previous purchaser is a revaluation, and accounted for as such. However, since this initial revaluation stems from the recognition, by the acquiring institution, assets, liabilities and contingent liabilities of the acquired identifiable, not imply that the purchaser has chosen to apply an accounting policy revaluation of these items after the initial recognition, for example following the IAS 16 Property, plant and equipment”.



Other regulatory references

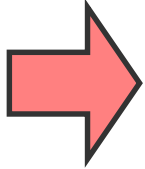
- European Commission (2004). Regulation n° 2236/2004;
- IASB (2004). International Financial Reporting Standards n° 1 – First-time Adoption of International Financial Reporting Standards;
- IASB (2004). International Financial Reporting Standards n° 3 – Business Combinations;
- IASB. International Accounting Standards N° 36 – Impairment of Assets;
- IASB. International Accounting Standards N° 38 – Intangible Assets.
- Regulation (EC) N.º 495/2009 de 3 de June de 2009 (IFRS 3 reviewed).

Merger Process: Accounting Aspects



- Applicable regulation;
- The principle of ‘fiscal neutrality’;
- Transferability of tax losses.

Merger Process: Tax Aspects



APPLICABLE REGULATION



Applicable regulation

□ **Main legislation applicable**

- Article 71^o No 2 of Code of Taxation of Income and Gains of Collective Persons (hereinafter “IRC Code”): Specific arrangements for the deduction of tax losses;
- Subsection IV from Section VI of IRC Code: Special arrangements applicable to mergers, de-mergers, transfers of assets and exchanges of shares;
- Article 74^o of IRC Code: Special arrangements applicable to mergers, de-mergers and transfers of assets; (Decree - law n.º 159/2009, July 13)
- Article 60^o of Portuguese Tax Incentives Statute (*Estatuto dos Benefícios Fiscais - EBF*): Companies restructuring as a result of acts of business combinations or cooperation agreements (Decree-Law No



Applicable regulation

□ **Specific arrangements for the deduction of tax losses (Article 71 of IRC Code)**

- “2 – Where, during the operation of the scheme, mergers occur among companies in the group or a company absorbs one or more companies from outside group, the losses of the merged company or companies incurred in years prior to the beginning of the scheme may be deducted from the taxable profit of the group to the extent of the taxable profit of the new company or the acquiring company, provided the authorization referred to in Article 69 is obtained.”



Applicable regulation

□ **Definition and Scope – Article 73 of IRC Code**

- “1 – A merger is a transaction involving:
 - a) The transfer of all the assets of one or more companies (merged company) to another existing company (acquiring company) and the allocation of shares to their members representing the capital of the recipient and, possibly involving also payments to them not exceeding 10% of the nominal value of the shares or, in the absence of nominal value, the accounting equivalent to the nominal value of the shares issued to them;
 - b) The incorporation of a new way (acquiring company), to which are contributed all the assets of two or more companies (merged companies), and the allocation of shares to their members representing the capital of the recipient and, possibly involving also payments to them not exceeding 10% of the nominal value of the shares or, in the absence of nominal value, the accounting equivalent to the nominal value of the shares issued to them;



Applicable regulation

□ **Definition and Scope – Article 73 of IRC Code**

- “1 – A merger is a transaction involving:
 - c) A transaction in which a company (merged company) transfers the whole of its assets and liabilities to another company (acquiring company) holding all of its share capital.”



Applicable regulation

□ **Tax benefits to corporate restructuring: Article 60 - Companies restructuring as a result of acts of business combinations or cooperation agreements**

□ To companies that, directly and principally, develop an economic activity with agricultural nature, commercial, industrial or service, and undergoes a reorganization as a result of acts of business combination or cooperation agreements may be granted the following benefits:

- a) Exemption from municipal tax on onerous transfer of property, concerning real property, non-residential, necessary for business combination or cooperation;
- b) Exemption from stamp duty regarding to property transfer referred to in paragraph a), or the constitution, capital increase or assets of a society



Applicable regulation

□ **Tax benefits to corporate restructuring: Article 60 - Companies restructuring as a result of acts of business combinations or cooperation agreements**

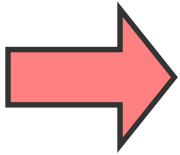
□ To companies that, directly and principally, develop an economic activity with agricultural nature, commercial, industrial or service, and undergoes a reorganization as a result of acts of business combination or cooperation agreements may be granted the following benefits:

- c) Waiver of fees and other legal costs that must be payable for the performance of the act included in the processes of business combination and cooperation.

Merger Process: Tax Aspects



APPLICABLE REGULATION



THE PRINCIPLE OF “TAX NEUTRALITY”



The principle of “tax neutrality”

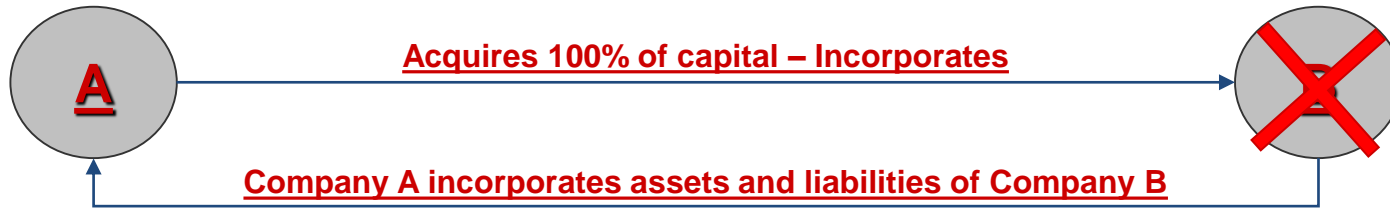
□ Principle of tax neutrality

- Tax neutrality is a term referring to the impact of taxation on the economy. When it is said that fiscal neutrality is desirable, the meaning is that the tax measure or policy should not introduce undesirable distortions into the normal working of the economy. This way the taxation shall not promote or hinder the process of business combination
 - «the tabulation of results relating to the assets transferred is done as if there had not been merger».
 - «In the sphere of the shareholders of merged or split off or acquired companies, there is no place to any taxation at the time of the transaction if they continue to value the new shares for the amount whereby the former were recorded..»

The principle of “tax neutrality”

□ Principle of tax neutrality

- Its always verified that:



Company A

- Resident in Portuguese territory;
- Assets and liabilities are accounted in Company A with a same values than they had in Company B;
- The values are result of IRC Code.

Company B

- Resident in Portuguese territory

Post Merger

Company A

- Amortization and depreciation are made using the same accounting methodology used in Company B;
- Provisions / adjustments transferred must have the applicable regulatory used in B;



The principle of “tax neutrality”

□ Application

- The property elements that are transferred must appear in the fiscal dossier of the new company, in order to control the property elements transferred and, this way, in order to proceed to the taxation later;
- The company with benefits should obtain the financial statements, of the merged company, before the operation of concentration of business activity.



The principle of “fiscal neutrality”

□ Application

- In case the companies do not respect the principle of tax neutrality, the incorporated company will have to proceed the taxation of the results of the operation, having two sceneries:
 - 1) recognize the existence of a negative goodwill, which will have to be taxed. However, in the other hand, the company will also be able to depreciate the items of Tangible or Intangible Asset, based on the Fair Value;

Merger Process: Tax Aspects



APPLICABLE REGULATION

THE PRINCIPLE OF “TAX NEUTRALITY”



TRANSFERABILITY OF TAX LOSSES



Transferability of tax losses

□ Authorization of Minister of Finance

- The reporting of tax losses is subject to authorization granted by the Minister of Finance:
 - Upon request of interested parties submitted to the Directorate General of Taxes (DSIT – Directorate of Inspection Services Tax) to the end of the month following the application for registration of the merger in the commercial register.



Transferability of tax losses

□ Article 75 of IRC Code

- “The tax losses of merged companies may be offset against the taxable profits of the new company or the acquiring company, on the terms and conditions set out in Article 47 until the end of the period referred to in paragraph 1 of the article, counting from the accounting period in which they arose the exercise that relate them, by permission of the Minister of Finance, upon request of interested parties delivered at the Directorate-General of Taxation by the end of the month following the submission of the merger for registration in Commercial Registry.”



Transferability of tax losses

□ Requirements with the demonstration that the merger is done due to right economic reasons, with the following attachments:

- a) A copy of the merger project;
- b) A demonstrative study about the economic advantages of the merger operation;
- c) A copy of an independent Auditor;
- d) A copy of the application to register the transaction in the competent Commercial Register;
- e) Information about predictable taxable profits of the new company or the acquiring company for the next 6 years after the operation;
- f) A copy of the financial statements of all companies involved in the operation, which has to make a reference to the last 3 years before the operation;



Transferability of tax losses

- **Requirements with the demonstration that the merger is done due to right economic reasons, with the following attachments:**
 - g) A copy of the estimated financial statements for the next 3 years after the operation of the new company or the acquiring company;
 - h) A document proving the absence of social security debts of the merged and acquiring companies.



Transferability of tax losses

□ Minister of Finance dispatch

- In dispatch can be set a specific plan of tax losses deduction to establish the scaling of the deduction during the period able to do it and can be defined the limits that can not be exceeded in each year.

According to **article 52º** of IRC code in each tax period the deduction of tax losses can not exceed 75% of the taxable results of the year.



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