CAMPAGNOLA ADVISERS

GGI GENEVA GROUP INTERNATIONAL

IBS ItalianBusinessSummit

M&A Operations – Tax Issues

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Taxation of corporate transactions and identification of the operation structure

The tax regime of corporate transactions:
- risks related to other entities and transferred to the "target"
- adequate due diligences activity

This note will explain the taxation system of company transactions, both concerning what was done previously by the "target" of the transaction (to verify the existence of risks related to other associations, but originally transferred to the "target"), and concerning a take-over in the context of which an adequate diligence shall be established.

- responsibility on the part of those involved: type of operation and limitation

In this respect we are going to highlight certain aspects.

First, we observe that the legislation provides for a liability pertaining to the parties involved, which depends on the type of transaction.

In greater detail, we point out that:

- obligations replacement (article 172, paragraph 4, Italian income tax code, TUIR)

- in the merger, the acquiring company or the company resulting from the merger will replace the old company in obligations both for direct taxes as stated by the article 172, ITALIAN income tax code);

- sale of companies (article 2560 Italian Civil Code)

- in the sale of companies, the Italian Civil Code (article 2560) states that *"... in the transfer of a commercial company the buyer of the company is also liable for debts ..., if they are recorded in the obligatory accounts books*";

- "certificate of tax pending charges" (art. 14 of Legislative Decree No. 472/97)

It may, however, be possible to limit assignee's liability by applying for a special certificate from the Italian authorities (so called "certificate of tax pending charges"); the transferee, in this case, shall only answer for debts coming from the certificate.

Share Deal – The search for *tax liabilities* in the *target company* (1 of 2)

Tax due diligence role

In company take-overs, the phase of tax due diligence plays an essential role.

This transaction is carried out as a rule by buyer's tax advisers and is mainly aimed at identifying potential tax liabilities not reported in the financial statements of the target company.

Direct taxation (IRES, IRAP and VAT) time terms for ascertaining

Both for direct taxes and for VAT purposes, the deadline for the assessment of a given tax period ordinarily expires on 31th of December of the fourth year following the year in which the TAX annual return is SUBMITTED.

Just for completeness, the term is extended until one year in case of failure to submit the TAX annual return.

With specific regard to the identification of tax periods defined or «closed », a very topical issue deserves to be highlighted: in greater detail, the Italian TAX LAW states that, both for DIRECT TAXES and FOR VAT, the ordinary four-year terms for assessment are doubled (hence passing to eight years) in cases of tax violations that may have criminal tax intents.

Asset Deal- search for *tax liabilities* in the target company or in a *target company business unit*

But there are also cases when tax due diligence is not contemplated.

The legal separation between the different business units of the company and their owner.

In such circumstances, due to the absence of a legal separation that exists between the different business branches of the company and their owner, it may be not useful for the buyer of the branch to conduct a survey on potential tax liabilities attributable to the seller, on the grounds that, both before and after take-over, the seller will remain the only single person, who any future tax assessments may be levied on.

Limits about taxes and penalties for violations committed by the seller prior to the sale of a business unit to the buyer.

There are limits to the above said rule. In fact, IT REGARDS ONLY taxes and penalties arising from violations committed by the transferring company in the year in which the branch was transferred to the BUYER and in the two previous years.

The “certificate of tax pending charges” (art. 14, Legislative Decree n. 472/1997).

In this situation, the deadlock may be avoided as it happened in a particular case using the already mentioned “Certificate of tax pending charges”.

Search for *tax assets* in the *target company* (1 of 2)

A secondary purpose of tax due diligence is to detect in the target company any deferred tax assets.

A further and not secondary purpose of tax due diligence is to identify the presence in the target company of any deferred tax assets.

Among these activities, the main one is represented by losses carried forward.

Among these activities, the main one is undoubtedly represented by tax losses carried forward. The importance of this type of activity is linked to the fact that the use in compensation of tax losses with income realized after take-over results in a tax savings and thus a reduction in the tax burden of the target company.

Transferability of tax losses: general rules.

For this reason, the losses carried forward are often subject to exploitation attempt by the Seller. It is important for the BUYER to check if the take-over of the company that make losses, may somehow limit their carry-forward in the future.

Generally the article 84, paragraph 1, TUIR that contain

GENERALLY a tax loss is calculable as a rule deducting it from tax periods income following that in which it was conferred, but no later than the fifth year. IN ANY CASE THERE AREN'T time limit FOR THE tax losses incurred in the first three fiscal years.

Law Decree n. 223/2006 and n. 262/2006 and unlimited carryforward tax losses requirements:

However, to limit the benefit of the carry-forward at the starting of a new business, the TAX Law has subordinated IT to SOME requirements.

Search for *tax assets* in the *target company* (2 of 2)

Having clarified the ordinary system of tax losses, it is time to analyze if and how the carry-forward could be compromised as a result of a take-over.

Article 84, paragraph 3 TUIR conditions

In this regard, the 3rd paragraph of the Art. 84 of the ITALIAN Income Tax Code states that the tax losses carry forward END to be as such when SOME conditions MET.

The clearly anti-avoidance rule states that a company having tax losses which may be carried forward, shall not be purchased by a person who desires to use its accumulated losses to offset future profits produced by an activity different from that which led it to the losses.

Art. 84, paragraph 3 TUIR "indices/rates of vitality":

Moreover, it shall be observed THAT THE LOSSES may be carried forward with no time limit if the company shall meet SOME 'indices of vitality"

(in brief, NUMBER OF EMPLOYEES LESS THEN 10 UNITS; THE amount of revenue and the amount of expenses for subordinate job performances and its contributions).

Deferred tax assets

THUS, the issue of tax losses shall be borne in mind when the tax due diligence is conducted.

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Tax – Consideration and rates (1 of 2)

Finally, it is time to analyze the taxation of the M&A operation.

Preliminarily, Italian companies are subject to corporate income tax (IRES) at a rate of 27.5% (24% as from the 2017 fiscal year) and regional tax on production activities (IRAP) GENERALLY EQUAL TO a rate of 3.9%.

An M&A transaction will qualify as a tax relevant or AS a tax neutral event depending on the type of transaction realised.

In general, there are some preliminary consideration about specific tax rules which are VERY important for M&A transactions.

IT'S THE case of **Partecipation Exemption (art. 87 TUIR)**: if the PEX regime applies, the seller may benefit from a 95% tax exemption of the realised capital gain for IRES purposes. The PEX regime applies provided that SOME conditions are met.

(SHARES HELD since 12 MONTHS; SHARES classified as "held for trading"; The company must carry out a business activity AND MUST not be resident in a black-listed jurisdiction).

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Tax – Consideration and rates (2 of 2)

Merger, de-merger and spin-off of a business unit are tax neutral events. No taxable capital gain arises from such transactions and, consequently, the transferred assets maintain the same value recognised for tax purposes. However, the taxpayer may opt – even partially – for the tax recognition of the eventual higher accounting value by paying a substitute tax ranging from 12% to 16%.

Mergers, de-mergers and spin-off of a business unit are BEYOND the scope of VAT.

Share deal (if individuals)

IN PARTICULAR CASES, Where an individual disposes of shares that constitute a 'qualifying interest' (THAT IT'S TO SAY, if they attribute to the holder a percentage of voting rights higher than 20%), ONLY the 49.72% of capital gains are subject to individual income tax at the applicable progressive tax rate.

In case of the disposal of shares that do not constitute a qualifying interest, a substitute tax of 26% applies on the capital gain.

WITH REGARDS TO Deductibility of notional cost of equity the Italian resident companies may deduct from their taxable base a notional interest computed on the new equity, that is, the amount of increase in equity over a 2010 base equity amount. For IRES purposes, the deduction is equal to a percentage of the equity increase (ranging FROM 4 to 4.75 PERCENT).

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Taxation of cross-Border M&A
- Asset purchase (1 of 2)

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

An asset deal allows the buyer to acquire only the assets actually needed, leaving the unwanted assets and liabilities behind. An asset deal may be used when a target company has significant contingent tax liabilities because it reduces the risk.

"certificate of tax pending charges"

AS SAID BEFORE, For this purpose, the buyer may apply for a "certificate OF TAX PENDING CHARGES".

In this case, the buyer's liability is limited to the amounts shown on the certificate

the book value of the assets

Moreover, specific warranties may be included in the sale and purchase agreement to protect the buyer.

In an asset deal, the book value of the assets is stepped up at the level of the buyer.

tax on the capital gain

The new book value is equal to the consideration paid for the business unit. The seller realizes a taxable capital gain AND The IRES tax on the capital gain can be spread over a five-year period if the business unit has been held by the seller for more than 3 years.

Essentially, in an asset deal, the seller is fully subject to tax on the capital gain realized, while the buyer obtains an increase in the tax basis of the assets purchased.

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Taxation of cross-Border M&A

- Asset purchase (2 of 2)

Goodwill

If the price exceeds the fair market value of the assets, the buyer may register this difference as goodwill in its accounts. Normally, the amortization of goodwill is tax-deductible over 18 years for IRES and IRAP purposes.

Depreciation

The tax depreciation of tangible assets is linked to and cannot be higher than accounting depreciation (established by a GOUVERNEMENT decree).

Tax attributes

Tax losses and other possible tax attributes are not transferred in an asset deal. They remain with the selling company.

Value added tax

According to VAT law, a transfer of assets is not taxable when a business unit is sold.

Registration taxes

Normally, the disposal of a business unit is subject to A registration tax of 3 percent. This tax rate is increased to 9 percent for real estate and decreased to 0,5 percent for receivables included in the business unit.

Taxation of cross-Border M&A

- Shares purchase (1 of 2)

INSTEAD,

PURCHASE OF SHARES

The disposal of shares is a tax relevant transaction for IRES purposes.
Capital gains and losses are generally excluded from the IRAP taxable basis.
The transfer of shares is a VAT exempt transaction and registration tax applies at the fixed rate.

a share deal: PEX regime

In a share deal, if the requirements for the PEX regime are met, only 5% of the realised capital gains are taxable.

the purchase of a target company's shares does not result in an increase in the base cost of that company's underlying assets

However, it is possible to step-up the tax basis of the target's underlying assets where, after closing, there is a merger between the acquisition vehicle and target company or, in certain cases, even without a merger.

Tax losses

Tax losses may be offset against up to 80 percent of taxable income in each year. AS SAID BEFORE, If tax losses are incurred in the first 3 years of activity and they refer to a new business, they can be offset against 100 percent of the taxable income.

Pre-sale dividend

In certain rare 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 lower effective rate of Italian tax.

Taxation of cross-Border M&A

- Shares purchase (2 of 2)

Share-for-share deal (contribution of a significant shareholding)

Where an acquisition is made by the purchase of shares in exchange for the issue to the seller of the purchaser's shares and the transaction is accounted for at book value, the gain may be rolled over into the new shares, thus enabling the seller to defer the Italian capital gains tax liability, in accordance with SPECIFIC rules.

Step-up of values

It is possible to step-up the tax basis of the target's underlying assets where, after closing, there is a merger between the acquisition vehicle and the target company.

Substitute tax

In this case, the step-up of the tax basis of the underlying assets is possible if substitute taxes are paid (RANGING FROM 12 TO 16%).

Goodwill and brands amortizing

Goodwill and brands are amortized over a minimum period of 10 years instead of 18 years.

Taxation of cross-Border M&A

- Asset vs/share purchase - a comparison (1 of 2)

ASSET PURCHASE	
Advantages:	**Disadvantages:**
• Step-up in the tax basis of the assets, so higher depreciation/amortization (including goodwill). • Previous tax liabilities of the seller are only partially transferred to the purchaser; 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 its own tax loss carry forwards, if any.	• Possibly unattractive to the seller, especially if a share sale would be partially exempt, thereby increasing the price. • Higher transfer duties usually arise. • Higher corporate income tax on capital gains. • Benefit of any residual losses incurred by the target company remains with the seller.

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Taxation of cross-Border M&A

- Asset vs/share purchase - a comparison (2 of 2)

SHARE PURCHASE	
Advantages:	**Disadvantages:**
• Likely more attractive to the seller from a tax perspective (because the disposal may be partially exempt), so the price may be lower. • Buyer may benefit from the tax losses of the target company. • Lower transfer duties are usually payable.	• Buyer effectively becomes liable for any claims or previous liabilities of the entity (including tax). • No immediate step-up in the tax basis of the purchased assets, including goodwill.