Tax and M&A

*M&A tax strategies face tougher scrutiny*

Aggressive tax management by multinationals, however legal, is in the public and political spotlight like never before, presenting clear reputational risks for M&A dealmakers. But how far will promised reforms go?

What's more, the growing political clamour about the erosion of corporate tax revenues – from political leaders in the UK, the US, France, Germany and Italy – does appear to be translating into action. Under instruction from the G20, the OECD is now conducting an 18-month review of international corporate tax strategies.

Called the Base Erosion and Profit Shifting (BEPS) review, it has set out an agenda of action, with deadlines. It is looking to see where tax policies can be harmonised to prevent corporations shifting their profits to low-tax jurisdictions, how governments can share information more effectively and how they can tighten their own anti-abuse and anti-avoidance rules.

For multinationals, there is one clear conclusion to be drawn. Not only do they now face much more vocal (and in some cases, direct) objections from the public on this issue, they must also accept that scrutiny by tax authorities will get considerably more stringent, as they have to be seen to respond to public and political concerns.

The tax debate has, without a doubt, been intensified by the politics of austerity. But while the heat may go out of the political debate once economic recovery in key jurisdictions gathers momentum, public opinion looks set to remain hostile for some time to come. Tax as an issue is here to stay.

Either way, multinationals face a new set of risks that will need to be managed with great care.

The M&A dimension

This debate has a direct bearing on corporate M&A. Companies may achieve tax benefits in the course of doing a deal – for example, selling a business without realising a taxable gain, or introducing tax-deductible acquisition financing. Alternatively, M&A transactions such as company and business sales within a group may be involved in implementing tax-efficient corporate structures.

Vodafone’s recent sale of its 45% stake in Verizon Wireless is an example of the former. It attracted criticism for using a Netherlands-based vehicle to conduct the transaction. The implication was that it did so deliberately to avoid UK tax, which ignores the fact that the UK would not impose tax on this sort of sale by a UK company.

Regardless of the technical merits, it seems that Vodafone will pay no tax on what is one of the biggest deals in corporate history, which has given the press and politicians plenty to consider.
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IP-rich companies are also increasingly in the spotlight, thanks to the difficult tax treatment of intangibles, such as trademarks and royalty payments. We have seen this in the ongoing Dolce & Gabbana case, which centres on the transfer of brand and trademarks from Italy to a Luxembourg entity and on last year’s challenge to the Valentino Fashion Group disposal by the Marzotto Group to Permira, where it was alleged that the capital gain realised in Luxembourg by Marzotto Group should be taxed in Italy.

Internet-based businesses are also in focus for locating their profit centres in low-tax jurisdictions, rather than paying tax in economies where they make huge sales. (Of course, the distinction between sales and profits usually gets lost in this debate.)

But the complexity of, often contradictory, tax regimes and rules is unlikely ever to be completely ironed out, despite the best efforts of individual governments, the G20 and the OECD. Changes will undoubtedly be made that may affect some of the ways in which deals are currently structured, but they are unlikely to involve wholesale reform of the global tax system. And, since most countries put great store by maintaining sovereignty over their tax regimes, there may be limits to how far the move to greater harmonisation will go.

We doubt that these changes will have a negative impact on M&A activity. Indeed, in a complex, global economy, some contradictions between competing tax regimes are likely to continue and may even act as a continuing spur to transactions.

But should the current reputational risks affect how dealmakers approach M&A transactions?

It is obvious that using tax avoidance transactions as a key driver of post-tax profits is becoming hard to defend. It is equally obvious that tax will be a relevant factor in commercial decision-making, and where the tax and commercial substance are aligned, there is no reason to avoid seeking tax efficiencies.

The key is to be able to explain the commercial justification for any tax benefit if the transaction is scrutinised. M&A transactions are highly commercial, and in general, there will be a good case to make for any resulting tax benefits. Precisely how M&A transactions are structured may have to change in response to the changing tax landscape, but tax will continue to influence whether and how deals are done.