Tax Considerations in Mergers & Acquisitions

In February 2006, the Federal Inland Revenue Service (FIRS) clamped down on a number of the emerging mega banks. It was revealed that of the 19 banks, which undertook varying forms of mergers and acquisitions (M & As), 7 had completely neglected their legal obligations to the tax authorities.[1] This negligence gives credence to the widespread ignorance that exists regarding the tax aspects of M & As. As a matter of fact, upon being confronted with the non-compliance, an official of one of the banks stated that it had only become aware of the legal requirements after the publication of the FIRS Notice.[2] The FIRS had earlier published an advert in the Guardian of February 6, 2006, reminding banks and other companies involved in recapitalisation, M & As, of their obligations to the Revenue.[3]

Tax considerations underlie all commercial activity.[4] Often times, they lurk like shadows just out of sight as the taxman monitors commercial activity awaiting the appropriate moment to spring tax assessments. Indeed there is truth in the popular saying that taxes are as certain as death.

The area of M & As is ripe with tax issues and due to the complexity of the considerations, it may sometimes happen that companies neglect or overlook these tax considerations. This neglect occasions both advantages and disadvantages for the parties. It may determine the availability of reliefs, expose the parties to enormous additional costs and make them liable to sanctions of the Revenue. Concern has been raised as to the capacity of the prevailing legal regime to adequately deal with the tax issues that arise in M & As. This paper

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[1] Akintunde O., *"Tax: FIRS probes 19 banks"* culled from Punch Newspapers, February 16, 2006. (www.efccnigeria.org)
[2] ibid.
[3] pp. 20.
[4] Poopola M. A., *"Mergers & Acquisitions- Tax Implications"* (unpublished paper delivered at annual CITN Tax Conference: May 2005)

seeks to identify those tax considerations and appraise their treatment under Nigerian law.

Definitions

The term merger appears to be one of imprecise definition. It has variously been described as a situation where two or more companies of approximately equal size come together with the shareholders and directors of both/all the companies supporting the combination and continuing to have an interest in the combined business,[5] as when firms of equal size combine with the smaller one normally being absorbed,[6] and as the amalgamation of the undertakings or any part thereof, of two or more companies.[7]

An acquisition is a more definite term; it is basically the purchase of one company by another with neither the shareholders nor directors of the purchased companies retaining any continuing interest in the enlarged company.[8]

In both cases, a single entity is usually produced from the combination of multiple companies. This combination has numerous tax consequences. First, it has the effect of reducing the number of taxable entities, which the Revenue can assess, to tax. Other issues that come into play are the existence and treatment of unclaimed losses carried forward and un-extinguished capital allowances. In addition, problems may arise regarding the reconciliation of accounting dates the determination of the basis period for the new entity. Also, issues will arise relating to procedural requirements provided by law for the execution of a merger or an acquisition transaction. All these issues will be dealt with in this paper. In addition, as M & As are basically constituted in transfers by one company of its shares or assets to another, the transfer creates other tax consequences. Issues

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[5] Balogun B., *"Tax Considerations for Mergers and Acquisitions"*, (unpublished) paper presented at the workshop on mergers and acquisitions organized by the Nigerian Insurers Association on Tuesday, December 14, 1999.

[6] Lustig P., Morck R. & Schawb B., *Managerial Finance in a Canadian Setting* (1994: Toronto, John Wiley & Sons 5th ed.) pp. 1.

[7] s. 590 Companies and Allied Matters Act (CAMA) 1990 *now repealed by s. 261 of the Investment and Securities Act (ISA) 1999.*

[8] Poopola M. A. op. cit.

will arise regarding the treatment of the transferee company's costs and the transferor company and its shareholders' gains.

Procedural Tax Issues

Amongst the sea of procedural requirements and approvals for executing a merger, are the requirements of the tax authorities. The Federal Board of Inland Revenue (FBIR) is in a privileged position as its direction is required by the Companies Income Tax Act (CITA), and must first be obtained before the consummation of any form of M & A.[9]

Section 25 (12) expressly states that no merger, take-over, transfer or restructuring of a trade or business carried on by a company shall take place without the FBIR's direction being first obtained. The sub-section further stipulates that the companies involved must obtain clearance with respect to any tax that may be due and payable under the Capital Gains Tax Act (CGTA).

The direction of the FBIR is usually obtained pursuant to an application submitted to it. The application must be submitted with a number of documents including the merger plans and audited accounts of the companies involved for the three years preceding the year of the consummation of the merger[10] and copies of the income tax computations based on these accounts.[11]

The FIRS has power to examine returns submitted to it by merging companies within a period of up to six years.[12] Also, in view of the ongoing consolidation exercises in the banking sector which were expected to produce increased M & A activity, the FIRS secured an understanding with the CBN that only an "approval in principle" will be granted by the apex bank pending the execution of the normal statutory post-audit exercise by the tax authority.[13]

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[9] Poopola M. A. op. cit.

[10] FIRS, *Notice To Banks and other Companies Involved in Recapitalisation, Mergers and Acquisitions.* (The Guardian Newspaper, February 6, 2006).

[11] Balogun B. op. cit.

[12] CITN *COMMUNIQUÉ ON POST MERGERS AND ACQUISITIONS-TAXATION ISSUSES* available at www.citn.org.

[13] FIRS, *Notice To Banks and other Companies Involved in Recapitalisation, Mergers and Acquisitions* op. cit.

M & As usually involve the cessation of business by one company and sometimes involve the commencement of business by a new company. Special rules exist regarding the determination of the basis period in these circumstances because of the difficulty or impracticability of applying the preceding year basis rules. The commencement rules are provided for in section 25 (3) of CITA while those for cessation are provided in section 25 (4). For their part, the cessation rules are to a certain extent compensatory.[14] While under the commencement rules, the profits of the 1st year are taxed two or three times, in cessation, the profits of another period will escape assessment.[15]

If companies with varying accounting year end dates wish to merge, they will generally have to adopt a uniform date for the merged entity. The normal rules under CITA allow companies to elect which accounting dates to make up their accounts to. The FBIR however has a right of election to charge tax on the higher chargeable profits based on either the old accounting date of the new one.[16] Notwithstanding this right of election, it appears that the FBIR has no right to reject the adopted accounting date.[17] Section 25 (2) of CITA stipulates only that the profits of the year in which the change occurs and 2 following years shall be computed on the basis chosen by the FBIR.

Clearly the Nigerian tax regime makes adequate provision regarding procedural issues for M & As. The prerequisite direction of the FBIR will serve to ensure that the Revenue is not sidelined in an arrangement, which will deprive it of a buoyant of truant taxpayer. It is however unfortunate that some companies have been able to complete their mergers without fulfilling the requirements of section 25 (12). It is hoped that such companies will be adequately sanctioned to discourage future breaches of the provisions.

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[14] Balogun B. op. cit.
[15] ibid.
[16] s. 25 (2)
[17] Adesola S. M., *Tax Laws & Administration in Nigeria.* (Obafemi Awolowo University Press, Ile-Ife; 1998) pp. 68.

It has been pointed out that the 6 year period for examining returns filed by merging companies is too long as merged entities will probably have concluded their mergers and commenced integrated operations by the time the period expires leaving them exposed to the possibility of surprise additional assessments.[18]

M & A Costs

M & As usually involve significant cost outlays in the form of professional fees spanning legal accounting, valuation and financial services as well as costs occasioned by regulatory authorities such as stamp duties and CAC filing fees.[19] Generally, section 20 of CITA provides for allowable deductions. The section lays provides the basic test of whether the expense is wholly, exclusively, necessarily and reasonably incurred in the production of the income. Also, the section further identifies specific expenses which will be allowed. The test in section 20 is akin to that provided by the Petroleum Profit Tax Act (PPTA), which was interpreted by the Supreme Court in the case of ***Shell Petroleum Development Company (Nig) Ltd v. FBIR***[20]***.*** In that case, the test was defined to allow the deduction of expenses solely and inevitably for the business. To this end, expenses in respect of scholarships the appellant was under obligation to give, where held to be allowable deductions in accordance with the test. One may be tempted to infer from the case that expenses in respect of government induced M & As may be allowed in accordance with the test, however, in view of section 23 of CITA, this cannot be the case. Section 23 of CITA provides that no expenditure of a capital nature shall be allowed as a deduction prior to the computation of profits for income tax purposes.[21] An expenditure of a capital nature is one made with a view to bringing an asset into being or substantially improving it.[22] M & A

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18 CITN *COMMUNIQUÉ ON POST MERGERS AND ACQUISITIONS-TAXATION ISSUSES* op. cit.

19 Central Bank of Nigeria (CBN) Technical Advisory Committee (TAC), *Report of Sub-committee on Accounting and Tax Issues* (March 2005) pp. 17.

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21 Ojo S., *Fundamental Principles of Nigerian Taxation* (2003: Sagribra Tax Publications, Lagos) pp. 559.

22 Ola C. S., *Income Tax Law and Practice in Nigeria* (2001: Heinemann Educational Books Nig. Plc) pp. 187.

expenses are therefore considered to be capital in nature and hence not deductible for tax purposes.[23]

M & As sometimes involve considerable job losses.[24]Major M & A expenses therefore usually include gratuity payments and compensation for loss of office. Regarding this head of expenses, section 20 (g) of CITA specifically makes it an allowable deduction subject to the expenses being in furtherance of a scheme approved by the Joint Tax Board (JTB). It used to be thought that where no approval was granted, although any gratuity provisions would not be allowed as deductions, however, any actual payments would be allowed in accordance with the basic test of section 20.[25] This erroneous view was corrected by the decision of the Body of Appeal Commissioners (BAC) in ***Nigerian Breweries Plc v. FBIR.***[26] In that case, the BAC emphatically stated that the only appropriate provision of CITA governing the deduction of gratuity and compensation payments is section 20 (g) and that the absence of JTB approval for the particular scheme is fatal to its deduction.

Another interesting consideration under this section is that of interest payments. Interest payments are specified as being allowable as deductions under section 20 of CITA. This provision is particularly important when the merger is financed with loan capital. It may also encourage the transferee to engage in tax planning by recharacterising some of the consideration for the merger as interest.[27]

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[23] CBN) Technical Advisory Committee (TAC), *Report of Sub-committee on Accounting and Tax Issues* op. cit. pp. 17.

[24] Lustig, Morck & Schwab op. cit. pp. 860.

[25] CBN Technical Advisory Committee (TAC), *Report of Sub-committee on Accounting and Tax Issues* op. cit. 20.

[26] Appeal No. 342/2002.

[27] Tarr A. J., *"Tax Considerations for Buyers and sellers of Companies"* (2002: Metropolitan Corporate Counsel Magazine) www.loeb.com/CM/Articles?articles109.asj.

Losses Carried Forward & Capital Allowances

The treatment of losses carried forward (loss reliefs) and capital allowances in M & As vary with the type of the merger and what is transferred in the integration process.

Generally, where the subject of the transfer is the assets of one company, both companies remain in existence. In such circumstances, as both parties remain in existence, each will be responsible for its own taxes and the transferee will generally not inherit the transferor's tax liabilities. It will however not be entitled to any of the transferor's losses carried forward.[28] This is because Nigerian law doesn't provide any form of loss reliefs for mergers.[29] It appears from the provisions of CITA that the loss reliefs in respect of the particular business will be held in abeyance. This is in view of section 27 (2) of CITA, which stipulates that loss reliefs shall only be deducted from the profits of the business in respect of which they are claimed. As the person entitled to the reliefs would have disposed of the business, neither of the parties may enjoy the reliefs. To avoid this practice, the Revenue has developed a practice of treating the losses carried forward as part of the assets of the company, which may be transferred as a result of an M or A. hence, the transferee company may enjoy the reliefs so long as he carries on business similar to that in respect of which the transferor became entitled to the reliefs.[30]

Where however, the main subject of the transfer is shares rather than assets, the position is different. A share purchase will usually preserve the loss reliefs so they can be utilized by the transferee after the merger.[31]

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[28] Chiltern, *"Assets or Shares-a tax conundrum"* (2005: M & A Tax Focus) pp. 1
[29] Oyetunde O., *Consolidation Reform of the Banking Sector"* [2005] journal of International Banking Law and Regulation pp. 283.
[30] Balogun B., op. cit.
[31] Field Fisher Waterhouse, *"Company acquisitions in the UK. A Guide"* (September 2004) pp. 2.

The preservation of loss reliefs may lead to dire consequences for the Revenue as it may encourage the trafficking in the shares of moribund companies with losses carried forward as their principal asset to facilitate the shielding by taxpayers of income of a substantially new trade with the losses carried forward a substantially extinct trade. This was the case in the UK prior to 1969.[32]

With capital allowances, M & As raise even more issues. Where the subject of the transfer is assets, the transferee generally receives a new basis in the assets.[33] The transferee will therefore usually be entitled to fresh capital allowances for qualifying assets.[34]

Where however, the subject matter of the transfer is mainly shares, the tax basis in tax basis in the transferor's assets will remain unchanged and the transferee will not be entitled to any allowances.[35]

Notwithstanding these general rules, section 25 (9) of CITA attempts to deal with M & As in Nigeria. The section provides for where a trade or business carried on by one company is sold or transferred for purposes of better management to a Nigerian company and the FBIR is satisfied that one company has control of the other or that both companies are controlled by the same person. In such circumstances, the FBIR may direct that all assets be deemed sold for the residue of the qualifying expenditure on the day after the sale/transfer.[36] The transferee will therefore be expected to take the assets at their tax written down value and will furthermore not be entitled to any initial allowances in respect of the acquired assets.[37] The provision also empowers the FBIR to waive the clumsy cessation and commencement rules of CITA.[38]

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[32] Weinberg et al, *Weinberg on Take-overs and Mergers.* (1971: London Sweet & Maxwell) pp. 253.
[33] Grimes W. B., *Tax Implications on the sale of a business"* (August 2004: W. B. Grimes, M & A services).
[34] Filed Fisher Waterhouse op. cit. pp. 3.
[35] Grimes W. B. op. cit. pp. 2.
[36] s. 25 (9)b CITA.
[37] s. 25 (9)c CITA.
[38] Poopola M. A., op. cit.

The section attempts to conclusively deal with capital allowance issues in M & As. It is however unduly restrictive. It has been identified that a considerable degree of ambiguity exists regarding mergers between related and unrelated companies.[39] The application of section 25 (9) is froth with problems. The section refers to a sale or transfer to a "Nigerian company". This indicates that the provision may not have been constructed for M & As but rather for indigenization of foreign companies.

Where applicable, the provisions will deny the transferor the ability to enjoy the tax advantage on the fair value of the assets acquired. The hardship of this treatment is perhaps most visible where the transferee has already fully claimed the capital allowances in respect of the acquired asset.[40]

Gains

Here too the tax consequences differ with the type of merger and the primary subject of the transaction. The tax implications of an asset transfer are not very attractive to the transferor or its shareholders. This is because the income is taxed twice, first in the hands of the company as capital gains and subsequently in the hands of the shareholders when the profit is distributed.[41] Where a portion of the consideration is re-characterised as interest, it will attract income tax at a higher rate than the alternative capital gains tax to which it would have been subject but for the re-characterisation. Where the payment is made in installments, tax will charged for each year on only the portion of the consideration received in that year.[42]

In addition, section 20 of the Capital Gains Tax Act (CGTA) permits the treatment of several transactions as part of a single disposal where the separate transactions are really part of a single bargain. This provision allows room for

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[39] CITN *COMMUNIQUÉ ON POST MERGERS AND ACQUISITIONS-TAXATION ISSUSES* op. cit.
[40] CBN Technical Advisory Committee (TAC), *Report of Sub-committee on Accounting and Tax Issues* op. cit. 18.
[41] Grimes W. B. op. cit. pp. 2.
[42] s. 18 CGTA.

some tax planning as a company may arrange its bargain so that gains from high profit disposals are grouped with low/no profit disposals to shield a larger portion of the gain from tax.

The tax consequences of a share transfer are generally more attractive to the transferor company and its shareholders. By virtue of section 31 of the CGTA, gains arising from the disposal of shares are exempt from CGT.[43] Furthermore, additional merger relief is provided by section 32A of the CGTA. By virtue of the section, where the merger is carried out by an exchange of shares without any cash consideration, any gain that arises will be exempt from CGT.

Other Tax Considerations

In any merger or acquisition, it will generally be necessary to execute numerous documents in respect of transferred properties and undertakings of the transferor company. Consequently, stamp duties will be charged ad valorem on the instruments executed.[44]

The parties to M & As may be entitled to stamp duty exemptions in certain circumstances. Section 104 of the Stamp Duties Act (SDA) provides for duty reliefs subject to certain conditions which include the requirement that at least 90% of the consideration for the transfer must consist in the issue of shares.[45] The duty reliefs cover exemptions with regards to conveyance and transfer instruments as well as duties on increase of share capital.[46]

Value Added Tax (VAT) liabilities may also arise in M & As. Input VAT on service and administration expenses and VAT expenses incurred in connection with capital assets are required to be expensed of capitalized in the tax payers'

[43] Balogun B. op. cit.
[44] Oyetunde O., op. cit. pp. 284.
[45] s. 104 (1)c SDA.
[46] s. 104 (3).

financial statements.[47] In some jurisdictions, it may be possible to obtain the earlier deduction of capitalized input VAT attributable to management expenses relating to M & As.[48] In other jurisdictions, transactions relating to M & As are exempt from VAT altogether. It appears that Nigerian VAT law lacks sophistication in this regard as there are apparently no specific provisions relating to M & As.

Finally, in concluding our discussion on the tax considerations in M & As, it is necessary to say something the Tax Due Diligence. As M & As generally involve considerable investments, legal, financial and strategic reviews of the transferor company are required to ensure the viability of the transaction.

It will be necessary to review the operating history of the company with regard to tax matters. Data on tax reporting and disturbing trends or inefficiencies in filing returns and assessments must be gathered.

In addition, it will also be necessary to ascertain available tax reliefs, determine outstanding tax liabilities, ascertain the credibility of the company's tax consultants, investigate pending queries and verify information submitted to the tax authorities.

Conclusion

On the whole, it appears that the Nigerian tax laws lack the kind of specific tax provisions relating to M & As which exist in more advanced countries like the US and the UK where M & As are common place activity in the corporate world. In Nigeria, M & As are still a relatively recent phenomenon and our tax laws have not yet evolved to adequately tackle them. It is hoped that with the increase in M & A activity, there will be reforms to ensure that the Revenue maintains minimum losses without interfering with the free enterprise rights of companies.

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[47] s. 13A VAT Act.

[48] Hammonds, *Tax Aspects of the Purchase and sale of Private Company Shares* 13th ed. (2004: LexisNexis UK, London) para 4.4.