.

The Specifics of Tax Arbitrage in The Reorganization of The European Companies Through Acquisitions, Mergers, Spin-Offs and Disinvestments

Anda Simona Rădulescu (Dîrvă)[1]
Cristian Dîrvă [2]

Focusing on fiscal issues, in this paper we analyzed the trend of European companies to streamline their activity through legal reorganization (i.e. takeovers, mergers, spin-offs, divestments) starting from tax benefits which may result from such operations.

Key words: tax arbitrage, mergers, acquisitions, spin-offs, disinvestments.

JEL Classification: G34, F38

[1]**Anda Simona Rădulescu (Dîrvă),** The Bucharest Universtity of Economic Studies, PhD Student, andaradulescu29@yahoo.com
[2] **Cristian Dîrvă** , The Bucharest Universtity of Economic Studies, PhD Student, cristian.dirva@gmail.com

Introduction

The takeovers across border through the exchange of shares (share for share exchange) represent an operation whereby a company takes over another company by the stock exchange between the acquiring company and the target company. (Hurduzeu, 2002). The transaction whereby two or more companies join together is called merger (Hurduzeu, idem). The assets and liabilities of the companies involved (without their liquidation) are transferred through a universal succession towards the new company. Through a division the assets and liabilities of a company are disinvested. They are transferred to one or more companies. The convertion of a company means changing the type of the company. The company remains in possession of the assets and liabilities held until the transaction. The transfer of assets (asset / capital transfer or assignement of property) requires that a company transferrs part or all of its assets and liabilities to other economic entities. The receivables, debts or the whole legal relationships, such as contracts with third parties are transferables as well.

The companies permanently evaluate the projects owned in order to decide whether or not to continue their division and disinvestment (Sweeney). Some projects may lose their feasibility (Umbenhaur, Rexford, 1999) due to increased cost of capital, local taxation, political risk in the region or revision of the projections for the exchange rates. For example, as a follow up to the crisis started in 2008 several multinational companies have restructured the operations performed as the estimates of future flows proved unfounded for several reasons: the economic downturn, decline in local sales and therefore the funds remittance; the depreciation of the local currencies etc.

Recently, more and more multinationals have manifested the tendency to reincorporate under favorable jurisdictions to minimize the tax burden (corporate inversion). This change of residence doesn't

bring significant changes on transactions or activities undertaken by the company, but most often comes along with the change of shareholding structure.

The first step in this process is the decision of the management and the shareholders of a company to incorporate a new company under a favorable jurisdiction, or even in a fiscal paradise. At the second step of the process can take two forms: (i) the exchange of shares: the new company acquires all shares of the initial company, and the latter becomes a subsidiary of the company incorporated in tax havens. In exchange for the shares they held, the first company's shareholders receive shares in the latter. The revenues from the sale of shares will be taxed. (ii) the exchange of assets: the new company receives in exchange for its shares the assets of the initial company which then will be discharged. The shares of the new company will be distributed to the shareholders of the initial company[3].

Although the company changes its country of incorporation, its operations do not change. The inversion occurs only on paper.

The motivatins for which the companies resort to such a strategy can be diverse. The main reasons for companies causing them to change their tax residence are: (i) taxation of income earned abroad, (ii) the tax treatment of interest costs and (iii) the income taxes paid by changing the source.

Despite the legality of the phenomenon of change of the residence tax and the high number of corporations which were expatriated in this way, there are many criticisms of it. Among the arguments against the phenomenon of "corporate inversion" can be found in decreased tax revenues to the state budget and the existence of negative consequences for the shareholders of these companies.

[3] **idem, p. 4.**

1. Mergers, acquisitions, spin-offs and divestments for tax benefits within the countries of the European Union

The challenges facing today's economy determine the companies to streamline their work in order to survive. Gradually, a number of regulations available to companies have emerged, particularly for those within the European Union in order to optimize the processes across the whole group. The number of reorganizations, both domestic and international is growing.

Thus, the European companies have begun to gradually take advantage of the provisions of the Directive 90/434 / EEC on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies from the different Member States[4] which have been partially or fully transposed into the national laws of the EU Member States.

The aim of Directive 90/434 / EEC is to abolish the tax obstacles (e.g. disadvantages or distortions of fiscal nature) the cross-border reorganizations of companies in the European Union might encounter[5]. More specific, the reorganizations covered by this Directive should not have the direct tax consequences on companies within reorganization or on the shareholders of the companies involved in reorganization.

Over time this Directive was subject to changes (i.e. Directive 2005/19 / EC, Directive 2006/98 / EC)[6], and at the end of 2009, was replaced by Directive 2009/133 / EC on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares wintin the companies from different

---

[4] „*Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States*", Official Journal L 225 , 20/08/1990 P. 0006 – 0009.

[5] European Comission, Taxation and Customs Union, "*Merger Directive*", aprilie 2010.

[6] European Comission, idem.

Member States and transfer of the registered office of a SE or SCE between Member States.[7]

Given the fact that certain European countries (eg Cyprus) have transposed into national law the provisions of Directive 90/434 / EEC, the reorganization of companies incorporated under their law is seen as an event-neutral tax, which brings many economic benefits to the European companies.

The provisions of this Directive have not yet been fully implemented in the European Union, and many of companies have to carry a quite high tax burden. Thus, cross-border reorganizations are preferred to local reorganizations.

On the other hand, the legal and fiscal and domestic policy to promote foreign investment, make Cyprus a strategic location for the European companies wishing to restructure through mergers or incorporating in holdings. Realizing the benefits that the provisions of European Directive 90/434 / EEC will bring to the country, they have been implemented into domestic legislation these provisions before Cyprus's accession to the European Union[8].

2. Tax arbitrage opportunities

Cyprus's domestic legislation transposing the Directive permits the exemption from taxation of profits resulting from the reorganization. At the same time, the transfer of land or capital gains are not taxed and they are exempted from the stamp duty. Following the

[7] Jurnalul Oficial al Uniunii Europene, Consiliul Uniunii Europene, "*Directiva 2009/133/CE a Consiliului*
din 19 octombrie 2009 privind regimul fiscal comun care se aplică fuziunilor, divizărilor, divizărilor partiale, cesionării de active si schimburilor de actiuni între societățile din state membre diferite si transferului sediului social al unei SE sau SCE între statele membre", L 310/34, noiembrie 2009.

[8] Stylianou, S., "*Cyprus: European directive helps Cyprus*", International Tax Review, Supplement - Mergers & Acquisitions, april 2010.

implementation of the provisions of the Directive into the domestic legislation, Cyprus became an ideal jurisdiction for the reorganization and restructuring of companies in the much-needed economic recession. The domestic mergers and acquisitions legislation plays a crucial role in the effectiveness of a transaction from the fiscal, legal or financial point of view and can be considered the country's competitive advantage in Europe alongside the other existing tax breaks. To illustrate the benefits of the Directive and how tax arbitrage is done, we considered *the following situation*:

A French company plans to invest in real estate in Romania, and another Cypriot company, faced with liquidity problems would like to dissolve, and it has already invested in this field in Romania, by buying shares in a Romanian company. Due to the implementation of the provisions of Directive 90/434 / EEC in the Cypriot legislationa huge opportunity for the company from France is created. The latter will be be able to merge with the company from Cyprus and will reach together with its shareholders to hold shares in the Romanian company. The direct sale of the stock of the company from Romania by the Cypriot company would have meant paying significant high fees for it. Following the merger, the Cypriot company will be able to transfer its assets to the French company and its shareholders will receive in exchange shares in the share capital of the company in France. Following this merger no fee is due in Cyprus, France and Romania. The existence of European laws, such as Cyprus, in accordance with Directive 90/434 / EEC permits the cross-border reorganizations, fiscally neutral and savings at company level. This directive aims to increase the efficiency of such reorganization which may take the form of takeovers, mergers, transfer of assets, exchange of shares etc..

The benefits of Directive mergers and acquisitions are:

- The company can deduct from its future profits the potential losses of the company it merged with, thus decreasing the income taxes that would have to pay;
- The exemption from tax on capital gains resulting from the transfer of goods from the reorganization;
- Transfer tax exemption on the transfer of immovable property during the reorganization.

3. Trans border takeovers through the exchange of shares and tax implications

The exchange of shares is an operation whereby a company acquires a shareholding in another company such that it obtains a majority of the voting rights in that company in exchange for the issue to the shareholders of the latter in exchange for their securities, of securities representing the capital of the company, and, if applicable, a cash payment not exceeding 10% of the nominal value or, in the absence of nominal value, the accounting par value of the securities issued in exchange value[9].

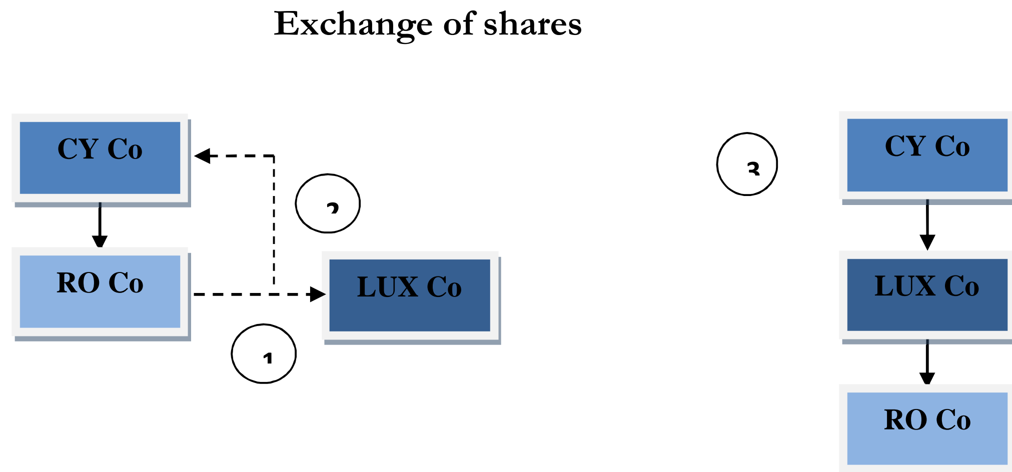
Thus, in accordance with the Directive, a Cypriot company can transfer its stake in the subsidiary from Romania in a company from Luxembourg in exchange for shares in the latter (Figure 1). The operation does not entail the payment of any fee in Cyprus .[10]

[9]„*Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States*", Official Journal L 225 , 20/08/1990 P. 0006 – 0009.

[10] Stylianou, S., "*Cyprus: European directive helps Cyprus*", International Tax Review, Supplement - Mergers & Acquisitions, aprile 2010.

Figure 1

Exchange of shares



1 – Transfer of shares from the Romanian company to the company from Luxembourg
2 – Issue of shares by the company from Luxembourg in exchange for the shares received from the Romanian company
3 –The new group structure

4. Cross-border mergers and tax implications

The merger is the operation whereby one or more companies transfer their assets and liabilities to another company, or several companies. The former are dissolved without going into liquidation. The shareholders of the company / companies transferring their assets-to-equity receive ownership (i.e. shares) of other companies (see Figure 2). Any cash payment which may occur after the transfer can not be

more than 10% of the nominal value of the shares or, in the absence of nominal value, the accounting par value of those securities.[11]

Therefore, the companies within the same group, may apply the provisions of Directive 90/434 / EEC and reorganize so without paying any fee.

For example, a Cypriot company may transfer its assets and liabilities to a sister company in the Netherlands (i.e. subsidiary of the same parent company) and its shareholders will receive in exchange shares in the Dutch company. Following the merger, the Dutch company will cease to exist (see Figure 3). For the merger to be done, a number of conditions and approvals should be met. The transaction is fiscally neutral in Cyprus.[12]

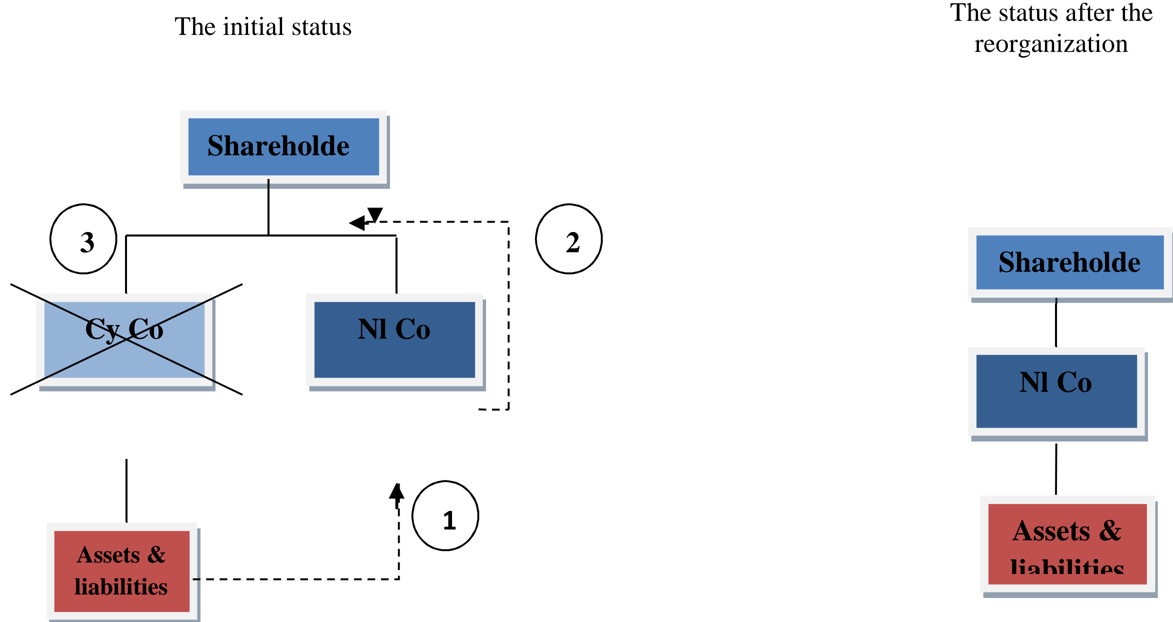
Equitsally, a merger can occur when a company is dissolved without going into liquidation and may transfer all their assets and liabilities to the the parent company (ie the company holding all the units representing its capital) (see Figure 4).

[11] „*Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States*", Official Journal L 225 , 20/08/1990 P. 0006 – 0009.

[12] Stylianou, S., "*Cyprus: European directive helps Cyprus*", International Tax Review, Supplement - Mergers & Acquisitions, aprile 2010.

Figure 2

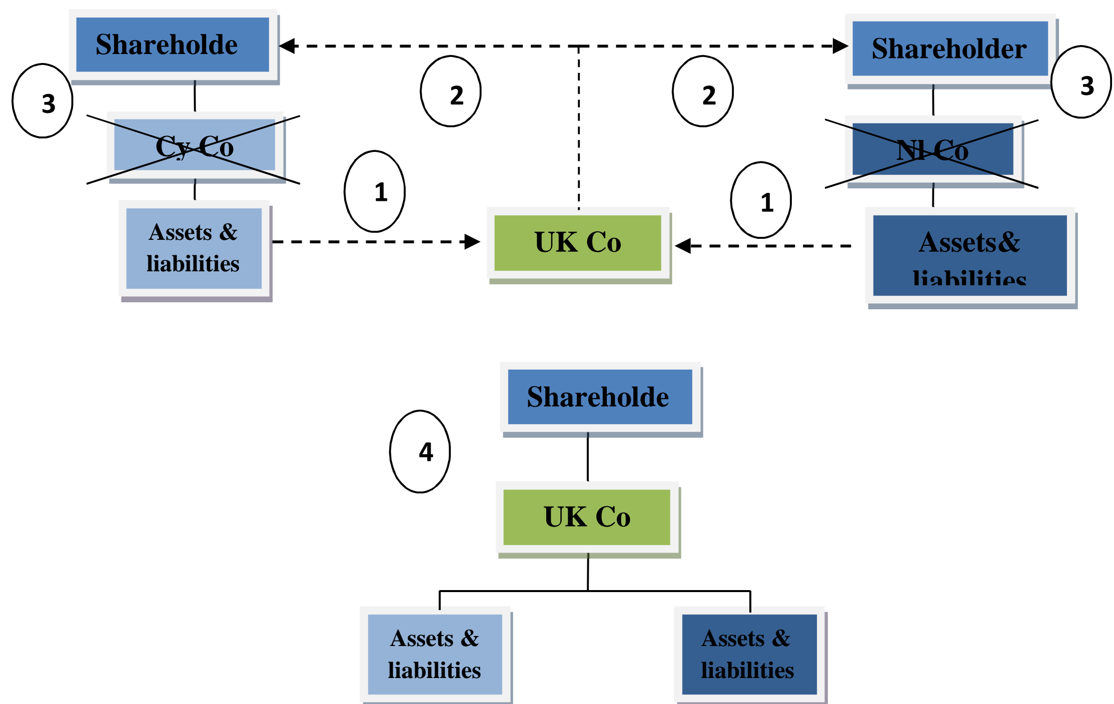
The merger between two companies within the same group



1 –Transfer of assets and liabilities from the Cypriot company to the Dutch company
2 –The Dutch company issues shares for the shareholders of the Cypriot company
3 – The Cypriot company is liquidated

Figure 3

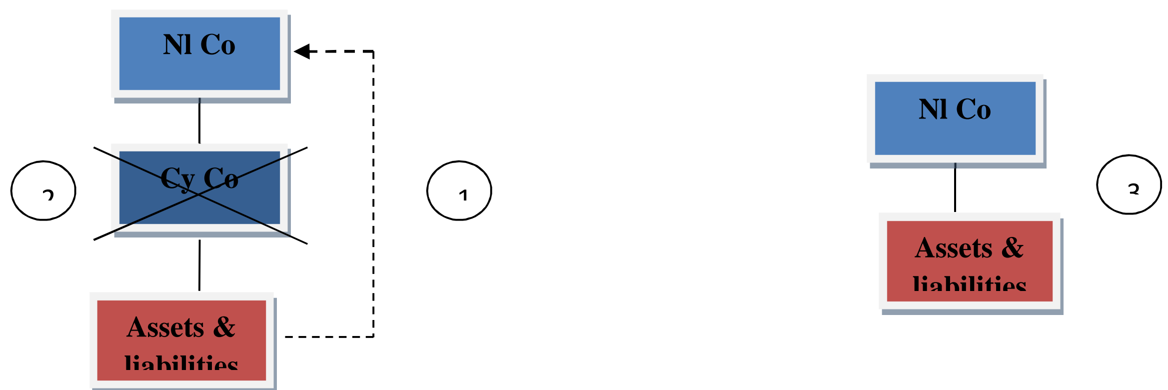
The merger between two different companies to form a new company



1 – Transfer of assets and liabilities from the Cypriot and Dutch company to the new company in the UK
2 – The British company issues shares to the shareholders Cypriot and Dutch companies
3 – The companies from the Netherlands and Cyprus cease to exist
4 – The new group structure

Figure 4

Transfer of assets / liabilities from the subsidiary to the parent company



1 –Transfer of assets and liabilities from the subsidiary to the parent company from Netherlands
2 –The company from Cyprus ceases to exist
3 –The new group structure

5. The Division and its tax implications

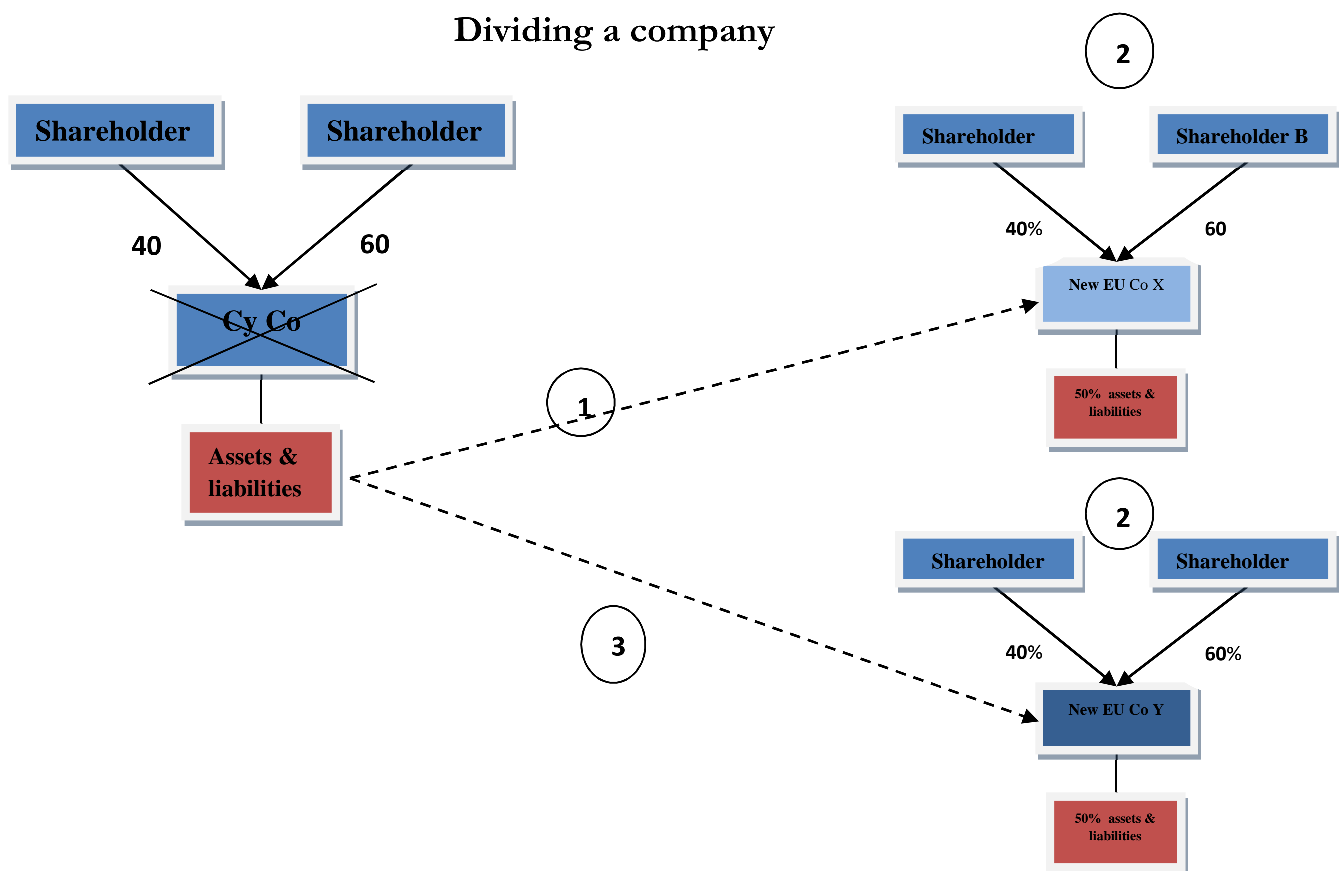
Dividing is the operation by which the entire assets of a company (assets and liabilities) is divided into several factions and sent simultaneously to several existing or new companies. The shareholders of the company / companies transferring their assets receive in exchange, shares of the company to which they are transferred to proportionately to the number of shares held in the old company and, if applicable, a cash payment not exceeding 10% of the nominal value

or, in the absence of nominal value , the accounting par value of the securities (see Figure 5).

In case of partial divisions only one branch of activity of the company is transferred, the company is not divided. The division is also a fiscally neutral event.

Figure 5

Dividing a company

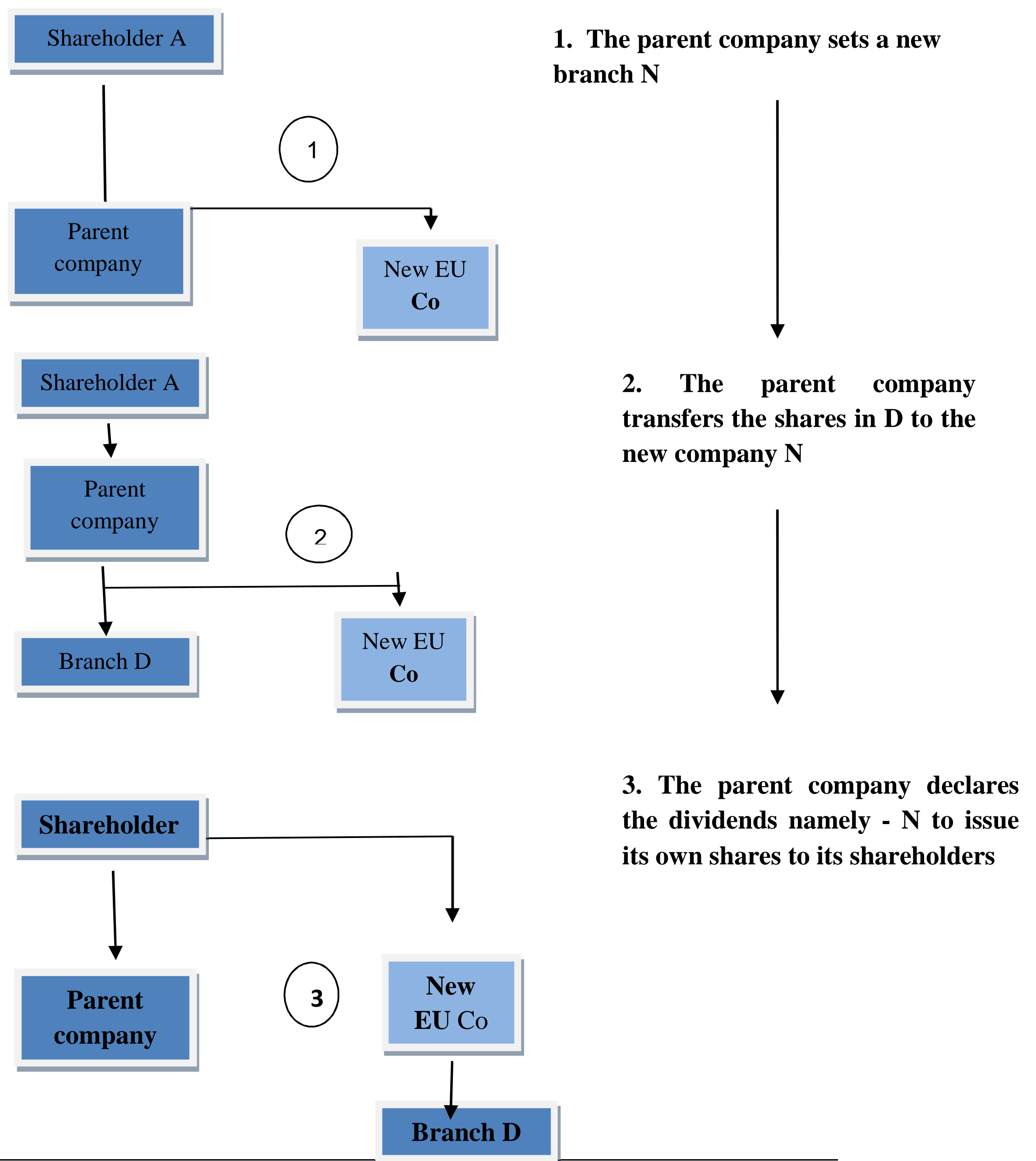


1 –Transfer of assets and liabilities of the company from Cyprus to two newly created companies (50% to 50% by Company X and Company Y)
2 –Companies X and Y will issue shares to the shareholders of A and B in proportion to their holdings in the company from Cyprus;
3 – The company from Cyprus will be dissolved

6. The disinvestment and its tax implications

In this case, a parent company sets up a new company (Newco) by transferring the shares it holds in the company to be divested. Meanwhile, the parent company gives dividends to its shareholders hoping the latter would be pleased with the new company - branch – it creates a positive trend - offering shares to itself and its shareholders. The result is that shareholders of the parent company hold shares in the new companyas well, but the new company does not depend on the parent company. The advantage is that the legislation regards this type of disinvestment as an exceptional distribution and thus the new shares received by the shareholders of parent company divested are not subject to tax. Several conditions must be fulfilled [noting with D (demerger) - the company to be divested, and P (parent company)]: (i) P needs financial strength to pay dividends to all shareholders; (ii) P must have sufficient distributable reserve to cover the company's D value.

Figure 6. The desinvestment of a company



1- The parent company transferres the shares in D to the new company N
2- - The parent company establishes a new branch N
3- - The parent company declares dividends namely - N to its own shares to its shareholders

Conclusions

Comparing the situation of legal reorganizations in Europe we concluded that due to the provisions favorable to reorganizations through mergers and acquisitions in some specific EU legislation, the companies registered in Europe prefer this type of arbitration.

Analyzing the tax treatment of various operations of reorganization through which Romanian companies may go , we were able to highlight the real benefits tax arbitrage can bring namely the efficient transfer of the tax from point of view of availability within the groups of companies, optimizing the flow of dividends and income tax due at group level, tax savings related to financing activities within the group, removal / deferral of taxation of capital gains, etc.

As the line between tax arbitrage, tax avoidance and tax evasion it is often vague and the strategies of the companies can be interpreted, we mentioned the position of the European legislation on this issue. Our conclusion is that circumstances may differ from one case to another and the assessment reorganizations should be done for each case. If the arrangement has economic substance underlying its legitimate commercial reasons and real economic activity, it cannot be considered as 'purely artificial'.

References

Boyle, M., "*Cross-Border Tax Arbitrage – Policy choices and Political Motivations*", British Tax Review, 2005.

Clymer, J., "*Tax Management in Companies" - "Coping with change*", International Tax Review, Tax Reference Library no. 44, 2009.

Eddins, S.T., Director of Research, IronBridge Capital Management LP, "*Tax Arbitrage Feedback Theory*", august 2009.

Fama, E.F., French, K.R., "*Financing Decision and Firm Value*", 1997.

Graham, J., "*Taxes and Corporate Finance: A Review*", Review of Financial Studies Nr. 16, pag. 1074-1128, 2003.

Hurduzeu Gh., *Achizitiile de firme pe piata de capital*, Editura Economica, 2002.

Mackie – Mason, J.K., "*Do Taxes Affect Corporate Financing Decisions*", Journal of Finance, Nr. 45, pag. 1471-1493, 1990.

Rosenbloom, H.D., „*International Tax Arbitrage and the International Tax System*", Tax Law Review, nr. 55, 2000.

Sweeney, P., *The Changing Face of the M&A Business'*, Global Finance.

Stylianou, S., "*Cyprus: European directive helps Cyprus*", International Tax Review, Supplement - Mergers & Acquisitions, aprile 2010.

Umbenhaur, I.; Rexford E., *Selling your business successfully*, John Wiley&Sons, INC., USA, Canada, 1999.

Very, P., *The management of Mergers and Acquisitions*, John Wiley&Sons, Ltd, UK, 2004.

Yla-Liedenpohja, J., "*Fiscal consequences of greater openness: from tax avoidance and tax arbitrage to revenue growth*", Helsinki, 2008.

***Harvard Law Review, "*Drawing Lines around Corporate Inversion*", pag. 3, 2005.

*** „*Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States*", Official Journal L 225 , 20/08/1990 P. 0006 – 0009.

***European Comission, Taxation and Customs Union, „*Merger Directive*", aprilie 2010.

***European Union Law, „*Parents-Subsidiary Directive 2003/123/EC*".

***European Union Law, „*Interest and Royalties Directive 2003/49/EC*".

***Jurnalul Oficial al Uniunii Europene, Consiliul Uniunii Europene, "*Directiva 2009/133/CE a Consiliului din 19 octombrie 2009 privind regimul fiscal comun care se aplică fuziunilor, divizărilor, divizărilor partiale, cesionării de active si schimburilor de actiuni între societătile din state membre diferite si transferului sediului social al unei SE sau SCE între statele membre*", L 310/34, noiembrie 2009.