



P+P Pöllath + Partners **Rechtsanwälte · Steuerberater**

Berlin · Frankfurt · München



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Tax Due Diligence

Summer Course M&A
August 11, 2009

Definition:

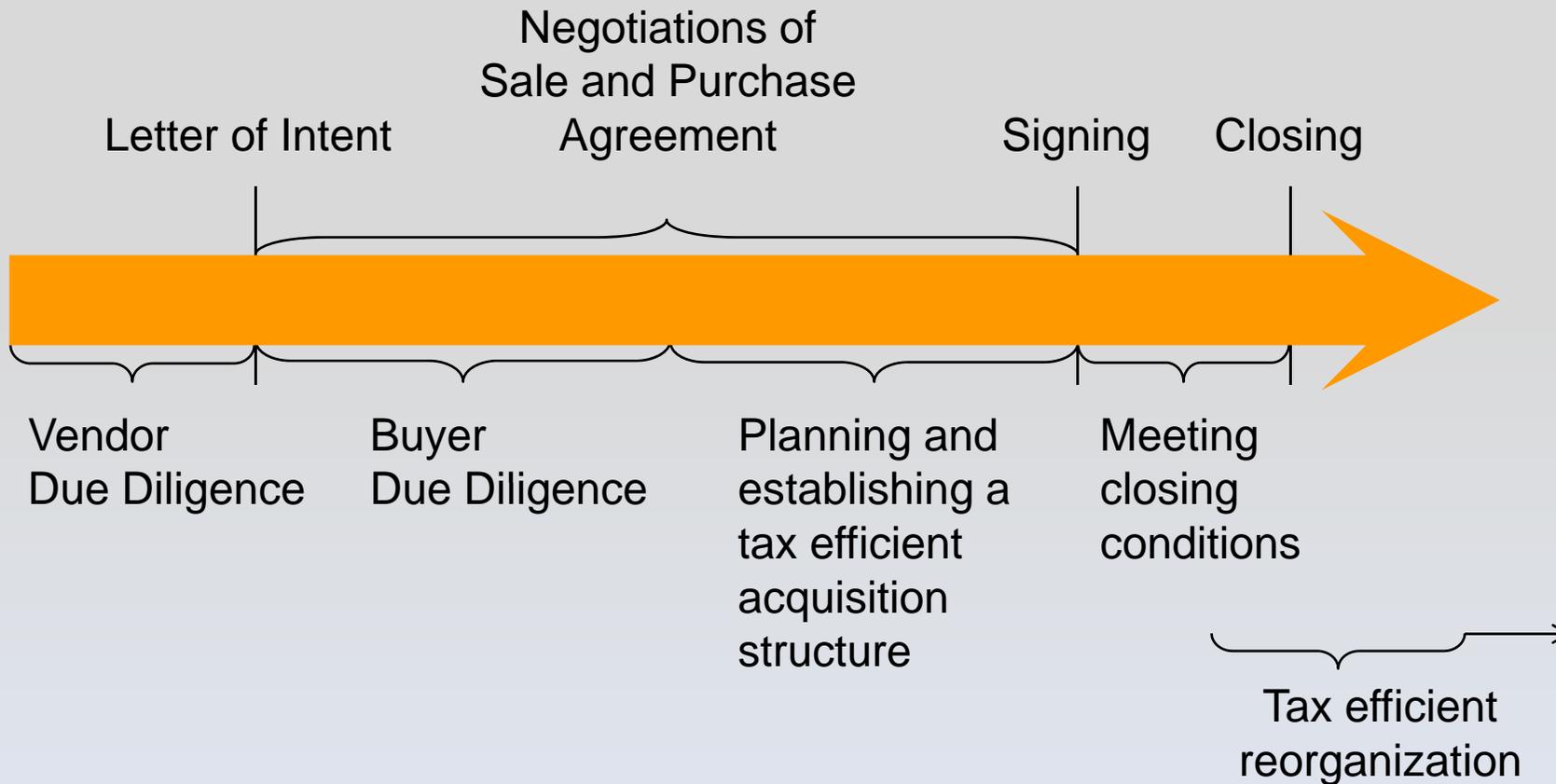
- Investigation of target entity / target group by potential buyer (respectively their tax / legal advisors)
- with a certain standard of care
- concerning tax matters
- basically on a voluntary / contractual basis
- to inform buyer side about tax status and tax risks at the level of target

A Tax DD is not

- an annual audit of financial statements
- a tax audit carried out by tax authorities

Occasion / Purpose

- acquisition of target by investor
- joint venture
- appraisal of business for going public / merger etc.



Tax Due Diligence: Objectives

Tax Due Diligence Process

Presentation of Tax Status

- Tax compliance status
 - Reconciliation from GAAP to tax income
 - Nominal and effective tax rates (entity / group level)
 - Status of tax consolidation (group taxation)
 - Status of tax losses / loss carry forwards
 - Tax audit findings
 - Status of tax grants / subsidies
 - Status of major VAT matters / custom duties
- Tax planning and financial forecast

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Identification of Tax Risks

- Disclosure / detecting tax risks (not yet included in tax calculation of target)
- Identifying deal breaker (if any)
- Calculation of purchase price deduction
- Calculation of "cap" regarding tax indemnity
- Basis for negotiations with respect to certain tax related guarantees

Establishing Acquisition Structure (step-in) and Exit Strategy (step-out)

- Efficient exit taxation at Seller level
 - Amortization of acquisition costs at buyer level (share / asset deal)
 - Transfer taxes (RETT)
 - Deductibility of financing costs (thin-cap rules, tax consolidation)
 - Further utilization of tax loss carry forwards
- Establishing tax efficient structure

- Income Tax (individuals)
- Corporation Tax (corporations)
- Trade Tax (individuals / corporations / partnerships)

- VAT
- Custom duties

- PAYE
- Capital Yield Tax (corporations / individuals and partnerships with respect to interest payments)
- Social Security Contributions

- Real Estate Transfer Tax (RETT)

Tax Risks / Tax Issues

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graph TD; A[Tax Risks / Tax Issues] --> B[Relating to past periods]; A --> C[Forward looking];
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Relating to past periods

• One time events

- Capital gain taxation
- Former reorganization
- RETT

• Revolving matters

- Annual tax computation
- Utilization of tax losses
- Tax consolidation
- Thin capitalization rules
- Major book to tax adjustments (GAAP to tax)

Forward looking

• „One time“ events (post acquisition reorganization)

- Restrictions for recapitalization and distributable GAAP-profit
- Composition of tax equity accounts (so called „EK-02 basket“, contribution account for tax purposes)
- Capital gain taxation
- RETT
- Binding tax rulings
- Required holding periods for tax efficient reorganization
- Transfer / further utilization of tax losses
- Debt push down of interest expenses

• Revolving matters

- Tax consolidation
- cash flow management (distribution of profits, cash-pooling)

Asset Deal

- § 25 HGB (Commercial Trade Code)
 - purchase of business entity / business unit (*Handelsgeschäft*) and
 - continuing the business name

=> Full liability of purchaser for debts due by seller in connection with business' activities (incl. tax)

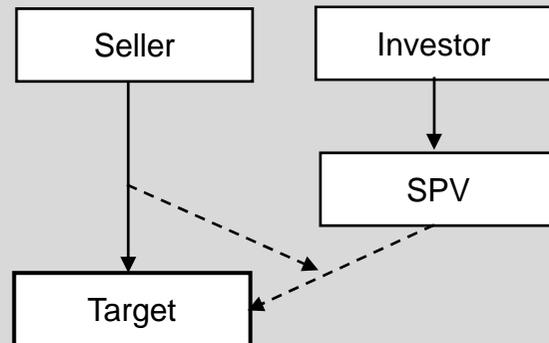
Advice: Liability can be turned away by publishing a limitation notice in commercial register (*Handelsregister*)
- § 75 AO (General Tax Act)

=> Purchase of business in total or business unit in total (*Unternehmen oder gesondert geführter Geschäftsbetrieb im Ganzen*)

 - Liability of purchaser is limited to:
 - business related taxes ("*Betriebsteuern*": trade tax, VAT, PAYE, capital yield tax, other withholding taxes, tax grants)
 - timing: taxes triggered within current or previous financial year of asset deal
 - timing: assessment of taxes within one year after change of ownership is disclosed to tax authorities
 - Volume: value of assets purchased

Share Deal

- Transfer of shares of legal entity: Legal entity is debtor and thus stays liable for all liabilities (incl. taxes)
- Management as legal agent of the entity is obliged to amend tax returns if misstated tax returns were filed before.
Otherwise: risk of tax fraud



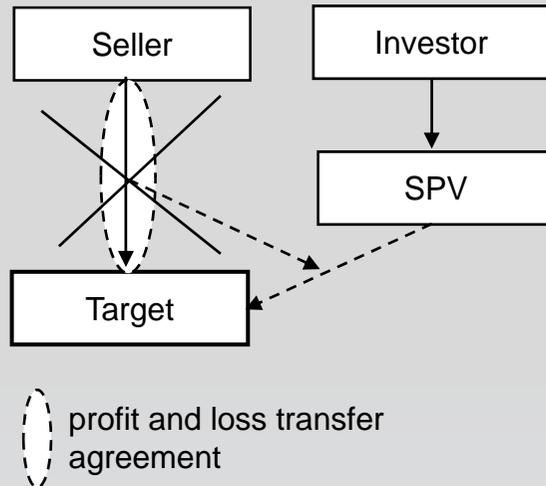
Tax Burden without compensation effect

Target did not add back non deductible exps (CT and TT effective)	2007 Adjustment	2008 Adjustment
travel expes, non deductible	15	20
entertainment, non deductible	30	25
Add. taxable income	45	45
Total additional tax (CT+TT)	18	13,5
	40%	30%

No add back for interest exps of 200 (TT effective only)	2007 Adjustment	2008 Adjustment
Add back volume (2007: 50%, 2008: 25%)	100	50
Add. taxable income	100	50
Additional TT (15%)	15	7,5
CT deduction (2007 only)	-3,75	
Total Tax Burden	11,25	7,5

Seller triggers constructive dividend at target level	2007 Adjustment	2008 Adjustment
overstated management fee to shareholder	100	100
Add. taxable income	100	100
CT / TT (2007: 40%, 2008: 30%)	40	30
Withholding Tax (net 21% but gross up to 26%)	26	26
Total Tax Burden	66	56

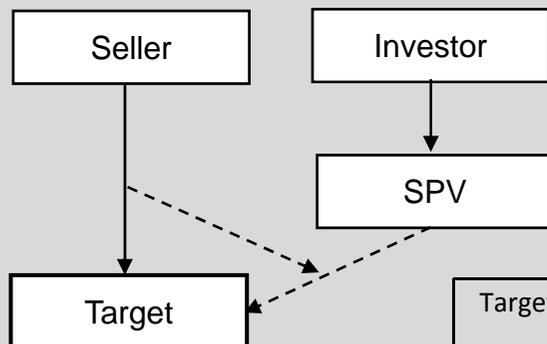
Tax Burden without compensation effect



Seller agrees p&l transfer agreement with Target in 2008 and files group consolidation in tax returns

	<i>Seller</i>	Target
<u>Tax calculation of tax unity group</u>		
Taxable income before group consolidation	-100	150
transfer of income für tax purposes	150	-150
Taxable income after group consolidation	<u>50</u>	<u>0</u>
Tax Burden CT+TT(2008: 30%)	<u>15</u>	0
<u>Adjustment due to failed to failed tax unity</u>		
Taxable income before group consolidation	-100	150
transfer of income für tax purposes	0	0
Constructive dividend for profit transfer	<u>7,5</u>	
Taxable income after group consolidation	<u>-92,5</u>	<u>150</u>
Tax Burden (2008: CT and TT 30%)	0	45
Third party liability for CYT (26%)		<u>39</u>
Total tax burden (56%), not compensated		84

Tax Due Diligence: Tax Burden III



Tax Burden with compensation effect

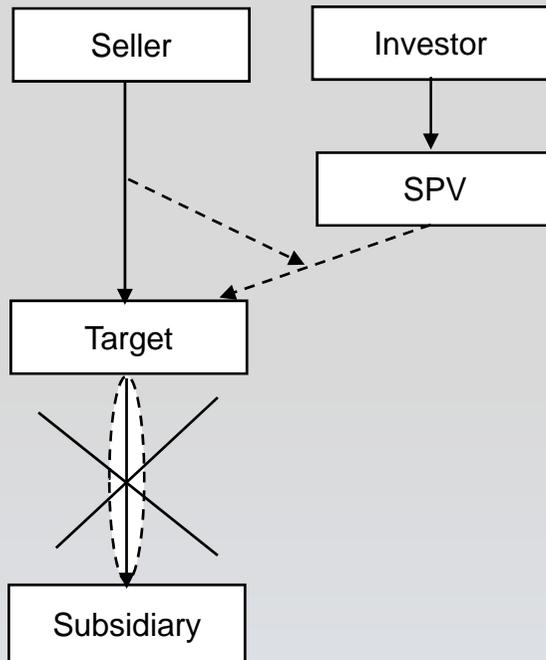
- Impairment of asset valuation for GAAP-purposes only
- Recognition of certain accruals / provisions for GAAP purposes only

Target GAAP and Tax Balance Sheet 2007 (before adjustment)			
Fixed Assets	100	Equity	80
<i>write down</i>	<u>(30)</u>	Accruals	50
	70		
Other Assets	100	Liabilities	40
Total	<u>170</u>	Total	<u>170</u>

Target Tax Balance Sheet 2007 (after adjustments)			
Fixed Assets	100	Equity	128
<i>write down</i>	<u>0</u>	Accruals	0
	100	Taxes	32
Other Assets	100	Liabilities	40
Total	<u>200</u>	Total	<u>200</u>

<u>Tax Adjustments for period 2007</u>	
drop away of write down	30
drop away of accrual	50
Total Adjustment	<u>80</u>
Tax Burden (2007: 40%)	<u>32</u>
<u>Disposal of assets in 2009 for proceeds 80</u>	
GAAP profit (proceeds 80 - net book value 70)	10
Tax loss (proceeds 80 - net book value 100)	(20)
Adjustment	(30)
<u>Cash out of 50 for accrual in 2009:</u>	
GAAP loss	0
Tax loss	(50)
Adjustment	<u>(50)</u>
Total Adjustemt GAAP to Tax	<u>(80)</u>
Tax Benefit (2009: 30%)	<u>(24)</u>
Tax Burden not compensated	<u>8</u>

Tax Burden with compensation effect

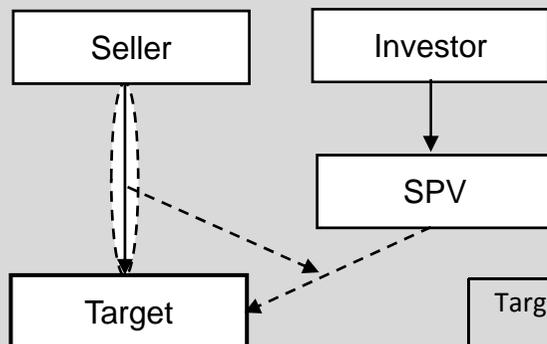


Target agrees p&l transfer agreement with Subsidiary in 2008 and files group consolidation in tax returns

	Target	Subsidiary	Total
<u>Tax calculation of tax unity group</u>			
Taxable income before group consolidation	-100	150	
transfer of income für tax purposes	150	-150	
Taxable income after group consolidation	<u>50</u>	<u>0</u>	
Tax Burden CT+TT(2008: 30%)	<u>15</u>	<u>0</u>	<u>15</u>
<u>Adjustment due to failed tax unity</u>			
Taxable income before group consolidation	-100	150	
transfer of income für tax purposes	0	0	
Constructive dividend for profit transfer	7,5		
Taxable income after group consolidation	<u>-92,5</u>	<u>150</u>	
Tax Burden (2008: CT and TT 30%)	0	45	
CYT (26%)	-39	39	
Total tax burden (56%), not compensated	<u>-39</u>	<u>84</u>	<u>45</u>
Tax refund at Target level, see above			-15
Deferred asset for tax loss carry forward *			-27,75
Total tax burden			<u><u>2,25</u></u>

* (100 - 7,5) x 30%; Might drop away by transfer of shares to Investor!

Tax Due Diligence: Tax Benefit



Tax Benefit at Target Level

- Impairment of asset valuation for GAAP-purposes only
- Recognition of certain accruals / provisions for GAAP purposes only

Target GAAP and Tax Balance Sheet 2007 (before adjustment)			
Fixed Assets	100	Equity	80
write down	(30)		
	70	Accruals	50
Other Assets	100	Liabilities	40
Total	170	Total	170

Target Tax Balance Sheet 2007 (after adjustments)			
Fixed Assets	100	Equity	160
write down	0		
	100	Accruals	0
		Taxes	0
Other Assets	100	Liabilities	40
Total	200	Total	200

<u>Tax Adjustments for period 2007 at Seller level</u>	
drop away of write down	30
drop away of accrual	50
Total Adjustment	<u>80</u>
Tax Burden (2007: 40%)	<u>32</u>
<u>Disposal of assets in 2009 for proceeds 80</u>	
GAAP profit (proceeds 80 - net book value 70)	10
Tax loss (proceeds 80 - net book value 100)	(20)
Adjustment	(30)
<u>Cash out of 50 for accrual in 2009:</u>	
GAAP loss	0
Tax loss	(50)
Adjustment	<u>(50)</u>
Total Adjustemnt GAAP to Tax	<u>(80)</u>
Tax Benefit (2009: 30%) at Target level	<u>(24)</u>
Tax refund to be payable to Seller if agreed in tax indemnification clause	

- Dataroom (physical or virtual)

- Financial statements
- Tax returns / tax assessments
- Tax audit reports
- Tax opinions of advisor
- Binding rules of tax authorities
- Tax calculation / forecast of current year
- Material agreements
- Documentation of former reorganisation
- Shareholder resolution

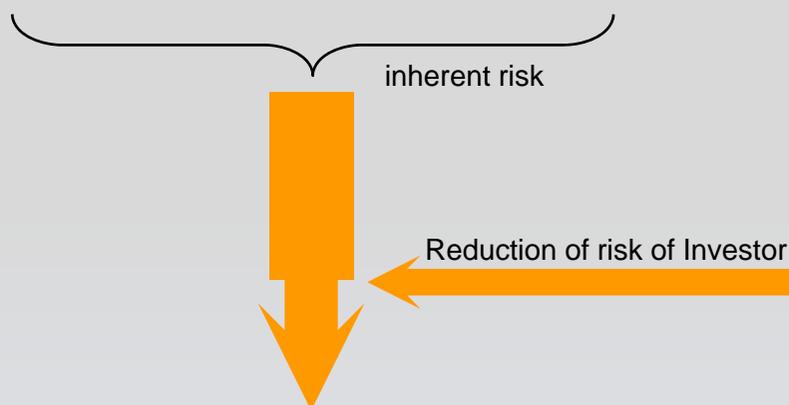
- Q&A Session

- Seller management
- Target management
- Advisor of Seller / Target

- Analyses of latest full scope tax audit report ("*Betriebsprüfungsbericht*")
- Tax consolidation (p&l pooling agreement, correct execution of profit transfer,....)
- Transfer pricing (intra group: domestic + cross border)
- Remuneration of managing shareholder (arm's length principle)
- Reorganization (merger, spin off, contribution in kind share to share transfer, change of legal form....)
- Book to tax adjustments (recognition and measurement of assets, accruals)
- Thin capitalization rules
- Utilization of tax loss carry forwards (share transfer, merger)
- Trade tax adjustments: add back of (long term) interest expenses
- PAYE: Stock options

Tax Due Diligence: Risk Position of Investor

- Complexity of business of Target
- Periods not finally assessed and not audited by tax authorities
- "risk appetite" of Target / Seller



- ↓
- SPA: - Tax indemnification
 - Tax guaranties
 - Escrow
 - Third party guarantor
 - Solvency of Seller / Guarantor
 - Purchase price discount

Remaining risk for Investor



Readiness of Investor to assume risk?