M&A considerations for 2017: Don't let tax derail the deal

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Laurence Field, Senior Tax and Corporate Business Partner, reflects on the M&A tax landscape that evolved through 2016 before looking ahead to assess what businesses need to know if they are looking to get a transaction over the line in 2017. Whether it is specific regulatory requirements that need to be observed, or a culture change in the treatment of tax as part of deal-making, he explains that while tax considerations will never make a deal, they certainly can break a deal.

Making an acquisition? Why tax is important

It seems that every time a Chancellor makes a formal speech or statement there are announcements about closing off tax loopholes. Some of these loopholes are not the result of smart, or even egregious, tax planning stretching the legislation to its limits, but shut the door on well-established and effective tax minimisation strategies. Regardless of policy-makers' motivations, those looking to engage in M&A activity in the next 12 months must remain vigilant and stay on top of new or incoming tax changes. For example, the UK's Autumn Statement confirmed that the Corporate Tax Road Map would be implemented and that there will be a new limitation on interest deductions for large groups, restricting interest deductions to 30% of earnings before interest and tax deductible allowances (EBITDA).

Tax strategies need to be reviewed to ensure they are still fit for purpose. Historically much tax due diligence has been backwards-looking: addressing the question of whether the right returns have been filed, at the right time, with the right amounts being paid. However, with the ongoing changes to taxes (not to mention political and economic uncertainties stemming from Brexit), tax due diligence needs to be increasingly forward-looking and the question arises over the extent to which existing strategies remain fit for purpose. What will the impact of already announced changes be? Will there be additional tax charges as governments both home and abroad implement policies based on their plans to maximise the tax take? With an increasing number of governmental 'hands' itching to get a share of tax revenues, dealmakers that operate across borders, in particular, will need to review their structures to ensure they are fit for purpose.

Upcoming changes in the UK

New limits on interest rate relief

From 1 April 2017 tax deductions in the UK for companies will be limited to, broadly, 30% of EBITDA. This means that companies with net interest expenses of more than £2 million could find themselves with less tax relief than they originally expected.

More flexibility on the use of losses

Groups with profits of less than £5 million will be able to use their brought-forward losses more flexibly from 1 April 2017, when these are incurred after that date. For groups with more than £5 million of profit, things could become harder with restrictions on the maximum amount of loss that can be offset against profits. An acquisition will obviously increase the size of the group cross these thresholds and the tax profile could change.

Taxable presence

The Organisation for Economic Co-operation and Development (OECD) has been working on proposals to try and ensure that profits are taxed in the country where they are earned. Current practice can result in a mismatch between where profits are earned and where the economic activities in earning those profits are allocated. Companies will need to review and understand the way in which they operate overseas to determine if they could have a different tax profile.

Why does this matter?

Tax is a key cost for a business. It has the ability to complicate or even kill a deal. Backwards-looking tax due diligence, while providing some comfort about the past, does little to help establish the tax profile for the future. With the tax authorities announcing new changes on a regular basis, working through the forecast impact on future cashflows should be an important part of the tax due diligence process. Our experience is that tax will rarely make a deal, but it can certainly derail one.

Almost two-thirds of financial professionals identified "overpaying for deals" as the biggest risk facing buyers in 2016 (according to Navigating the Risks of the Contemporary M&A Market, a 'strategic buyer' survey conducted by the Financial Executives Research Foundation (FERF) and Crowe Horwath International (CHI)). The risk of overpaying on a deal can be mitigated somewhat by prudent pre-acquisition transaction planning. Ensuring your structuring stays clear of tax traps will therefore continue to be a priority for dealmakers in 2017. In light of the direction of travel in the regulatory environment, which is unequivocally towards greater transparency and reporting requirements being placed on taxpayers, this is more important than ever because structures are being scrutinised by authorities that have access to increasingly detailed levels of financial information under new disclosure standards.

With "identifying potential tax risks" and "the need for a tax efficient structure" is listed by FERF/CHI as low-down concerns for company boards when it comes to categorising valuation risks. Overlooking future tax risks could be as costly as failing to identify historic ones. With Brexit on the horizon, post- deal international risks include tax issues such as dividend repatriations, where business may need to rely on bi-lateral treaties as opposed to EU Law. Corporate residency, for tax purposes, is a potential post-closing tax issue to contend with, but this hinges on whether the acquirer is seeking to move headquarters (as in the case of inversion).

The bigger picture

The international picture must also be considered, given the volume of cross-border deals as a proportion of total deal activity. M&A activity in the US is fighting against strong regulatory currents. Anti-inversion sentiment, making it harder to perform an inversion and reducing the tax benefits attached to inverting, remains and legislative steps to counter this structuring technique has come in stages. Competition regulation is also a factor to be considered. In Europe, Margrethe Vestager, the Competition Commissioner has wielded her powers under state aid proceedings against EU member states and predominantly US-owned companies in recent times, and transactions have been blocked by regulators around the world during the past 12 months. The rules governing corporate use of debt and equity and legislative reform to bring greater parity to the tax treatment of each source of funding will also impact deal activity in the year ahead.

Political uncertainty driven primarily by the election of Donald Trump as the incoming US President and by the UK's Brexit decision to leave the EU, will further impact business confidence and therefore transactional appetites. The growth of right wing nationalist groups around mainland Europe, in particular, could have a spill-over effect economically if cross-border transactions fall in volume. Countering this uncertainty is the fact that corporates have strong cash reserves and interest rates remain relatively low. However, uncertainty is the biggest threat to boardrooms choosing to progress deals.

Looking back on 2016, we see that European M&A activity dropped in the first half of 2016 due to political and economic uncertainty stemming from the decision to leave the EU. This is in conjunction with the US Treasury's attempts to clamp down on inversions, with European countries, chiefly the likes of Ireland, which has an attractive headline tax rate and serves as a gateway to expanding business in Europe being the typical post-merger headquarter destination for the majority of inversions. The biggest dip in year-on-year deal activity came in the months leading up to, and immediately following, the Brexit vote. The decrease in European M&A deals involving a US acquirer fell by almost 70%.

Savvy dealmakers will be wise to remain aware of the fact that other countries throughout Europe will be seeking to capitalise on Brexit-related uncertainty and the resultant unstable investor sentiment. The potential implementation of legislative reforms that make transactions easier or more attractive should therefore be monitored in countries like France. Even reforms that don't specifically target M&A tax provisions, but which simply make the country a more attractive location to operate in, will benefit deal-making involving French companies.

Business fluidity to aid smooth deal flows

Tax should be considered as a routine business cost and appropriate due diligence and planning should therefore go into tax considerations ahead of targeting any deal work. Costly tax surprises may arise as the implementation of deliverables from the BEPS Project gathers pace. The importance of business interactions across various departments is an essential part of mitigating these potentially costly tax surprises. The C-suite, HR, finance, tax, legal and IT departments all need to be engaged and interconnected to understand tax issues.

As we embark upon a new year of dealmaking, challenges are aplenty. But, on the tax side, many of these challenges are perfectly manageable and with proper planning should not prevent a deal from going through. CFOs and finance professionals must focus on risk assessments not only about the past but also the future. While some risks are environmental, many are well within the control of the acquirer to vet pre-deal and subsequently mitigate post-deal.

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