Rödl & Partner

M&A DIALOGUE

LEGAL, TAX, FINANCIAL NEWS

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→ Accounting in M&A deals - often neglected

M&A transactions regularly present both buyers and sellers with multiple challenges. In the complex and often time-critical M&A process, one important aspect often misses out. The accounting is often treated like a poor relation when faced with so many other urgent issues. However, its importance for the successful completion of M&A transactions should not be underestimated. In the following, based on some typical examples, we look at which parts of the M&A process need to be reviewed early on with questions concerning the accounting, in order to anticipate and counteract as soon as possible any unintended side-effects in the financial statements of the parties involved.

DUE DILIGENCE

In advance of a planned M&A transaction, performing a due diligence process serves to obtain a better understanding of the transaction target at an early stage. As part of the so-called financial due diligence, a high priority is an analysis of the company's asset, financial and earnings situation based on accounting information.

Since the figures presented will depend substantially on the accounting methods applied (local GAAP, IFRS, etc.), an in-depth dealing with these is absolutely essential. An analysis of financial information can only be meaningfully carried out where there is a shared accounting language. Especially where financial information has been derived using local accounting standards (including, for example, the German Commercial Code [HGB]) but the buyer works with IFRS, then a so-called IFRS quick check is highly recommended. This provides an overview of how the figures would change if the internationally accepted IFRS had been applied, so allowing the buyer to apply comparisons to the transaction target.

CONTRACT DESIGN

Accounting can also have a considerable influence on the design of the contract itself. Very often so-called earn-out clauses are used to link subsequent purchase price payments to the development of financial indicators (e.g. EBIT or EBITDA). The determination of these key figures and, therefore, ultimately the purchase price itself, depend on the underlying accounting methods. This means that attention has to be paid also when drafting the contract to ensure a clear definition of the relevant figures, and to establish any necessary adjustments. In particular, it needs to be defined how any potential changes in the underlying accounting standards over the contract term should be handled. For example, the initial application of IFRS 15 (revenue recognition) in 2018 resulted in changes concerning the periods in which revenue is recognised for many companies. The extensive changes created one year later by IFRS 16 (accounting for leases), led to a considerable increase in EBIT in many companies. Such effects, that are not based on economic circumstances, but rather arise from changes in accounting methods, should be addressed in the purchase agreement to avoid surprises later on. The accounting system can also play a role when evaluating force majeure clauses, which can influence earn-out figures in the event of serious, unexpected events beyond the control of the contractual parties (Corona pandemic?).

PRELIMINARY PURCHASE PRICE ALLOCATION AND POST-MERGER INTEGRATION

In addition, buyers should give some thought before signing a contract to how the financial reporting will change after its closing. On the one hand, this concerns the accounting treatment of the M&A transaction by the acquiring company itself. In this context, a preliminary purchase price allocation (pre-PPA) should be carried out in order to make the resulting impact on the balance sheet transparent early on.

Once the transaction has been successfully completed, on the other hand, the transaction project has to be integrated (post-merger integration). In this area, changes to the accounting may be necessary, e.g. if the previously applied accounting standards are different between the acquiring company and the target company. To ensure its success, a change in the accounting, e.g. switching to IFRS, involves very important procedural and IT aspects that require consideration alongside professional aspects (incl. necessary training for employees). In this regard, it is worth taking the trouble to examine the requirements at an early stage.

CONCLUSION

In an M&A process, the importance of accounting is often underestimated, although this is absolutely one of the critical factors for success. Therefore, as part of due diligence, the impact of the applied accounting methods on the determined financial figures should be analysed. Also when defining earn-out clauses and preparing the post-merger integration, an early consideration of accounting-related effects of the transaction can help to guarantee a successful implementation with no hidden surprises.

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→ Italy: Photovoltaic portfolios. Assignment of corona superbonus

Italy is and remains an interesting country for investments in the area of renewable energy. The secondary market for small and medium-sized photovoltaic systems (PV systems) offers good investment opportunities with the goal of building up photovoltaic portfolios. In addition to this, the disaster of the Covid-19 pandemic has brought something positive. The Italian government has introduced a tax deduction (referred to as the superbonus) of 110 percent of the costs implemented for energy efficiency measures, which include buildings and installations with photovoltaic systems. The superbonus can be re-assigned by the beneficiaries.

STANDARDISATION OF THE PURCHASE AND INVESTMENT PROCESS

What matters most when creating a portfolio of small and medium-sized PV systems (with a capacity ranging from approx. 600 kW to approx. 3 MW), is standardising the purchase and investment process. The larger the portfolio, the higher the returns. An efficient investment model is particularly important.

An investment process like this requires the following standard documents in particular:

- a *non-binding offer* template with a purchase price on a defined *reference date*;
- an efficient *due diligence* process;
- a standard purchase agreement (*quota purchase agreement*), which should be fairly balanced between the buyer and seller, and should contain such clauses (*R&P, indemnification, CAP, de minimis*, etc.), that the vendor party will normally expect because market standard, in order to avoid unnecessary negotiations;
- an efficient and rapid *post-closing* phase, as part of which, following the *closing* and based on the final balance sheet on the date of closing (*Closing Date*) checks are carried out to ensure

that all the agreed expenses/liabilities are in line with the final purchase price calculation;
- an escrow deposit (*Escrow*), normally be about 10 per cent of the purchase price, which is made in order to cover any claims by the buyer against the seller for expenses/liabilities (*leakages*) not covered by the contract and not agreed upon at the reference date;
- further *Escrows*, where amounts are deposited to cover potential risks determined during the due diligence.

DETERMINATION OF THE FINAL PURCHASE PRICE

As a basis for negotiation, the purchase price is usually agreed to be the *enterprise value debt/cash free* as of a specific reference date. The final purchase price at the closing ("*equity value*") is determined on the basis of a balance sheet drawn up as of the reference date. Net financial liabilities and, if present, any shortfalls in the agreed level of current assets, must either be deducted from the final purchase price or transferred to the buyer after the *closing* from the *escrow* deposit as part of the *post-closing* process. In the reverse case, the *escrow* amount should be transferred to the seller.

IMPROVEMENTS

Improvements include measures of a technical, economic and financial nature that allow a subsequent increase in the actual returns of the investment. Technical improvements might be, for example, the replacement of components (modules, inverters, etc.) to increase the electricity generated. Economic improvement measures might include the use of a single service provider for the entire portfolio (O&M, safety, insurance, etc.). Financial *improvements* are mainly found in the optimisation of existing financing terms by renegotiating or completely refinancing the entire portfolio. The latter currently offers great opportunities to increase returns at the portfolio level.

COVID-19 SUPERBONUS FOR ENERGY EFFICIENCY MEASURES AND RE-ASSIGNMENT

During the Corona-19 pandemic, Italy has adopted a package that increases the existing tax deductions for energy efficiency measures from 50 or 60 to 110 percent of the expenses. The term of the tax deduction has been reduced from 10 to 5 years. The superbonus applies to the installation of photovoltaic systems and solar thermal energy, as well as to heat-insulating windows, among other things. To qualify, the specified measures must be linked either to improving heat insulation of buildings or to the replacement of oil or gas heating by heat pumps, possibly also through geothermal systems. The energy classes of the buildings or apartments must improve by at least two classes on the energy scale.

The beneficiaries of the superbonus can claim it by deducting a discount from the purchase price from the supplier, or by re-assigning it to the supplier.

CONCLUSION

The creation of portfolios of small and medium-sized photovoltaic systems in Italy may represent an interesting investment opportunity. The purchasing process should be standardised and managed in a consistent way. There are market *players* who have already introduced the model and have been very successful with it. Especially by making *improvements* to the investments, there are good chances of increasing the returns. With the 110 percent Covid-19 superbonus, investors can consider investing in those companies that are making lucrative margins thanks to the discounted assignment of the tax deduction, or even getting into this business themselves.

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→ Obligation to report cross-border tax arrangements

In particular in the course of a cross-border company transaction, structural considerations for the tax-optimal acquisition of the target company are made. The goal is to set up a structure that optimises tax as far as possible, e.g. by exploiting tax rate differentials or reducing or avoiding withholding tax on future dividends.

EU Directive 2018/822 dated 25/06/2018 was implemented in national German law by a law that introduces a duty to report cross-border tax-planning arrangements. The goal of these regulations is to reveal aggressive cross-border tax-planning arrangements and so increase tax transparency. From these reportings, it should be possible to derive future guidance for tax legislation.

WHAT HAS TO BE REPORTED?

The obligation to report covers basically cross-border tax-planning arrangements relating to any type of tax apart from VAT, customs duty and harmonised consumption taxes (e.g. energy, electricity and tobacco tax). In particular, it covers corporation tax, trade tax, income tax, inheritance and gift tax, as well as non-harmonised consumption taxes, such as the tax on coffee.

A tax-planning arrangement is the deliberate introduction or change of an actual or legal situation that is relevant for tax. A tax structure is cross-border when more than one EU member state or at least one EU member state and one or more third countries are involved, with the parties being resident in different countries. A reporting obligation exists in Germany if one of the persons subject to the reporting obligation has a nexus to Germany. However, the reporting obligation is only triggered if the relevant hallmarks are fulfilled. With regard to the hallmarks, a distinction is to made between mandatory hallmarks and conditional hallmarks. If a mandatory hallmark is fulfilled, then this on its own triggers a reporting obligation, while the existence of a conditional hallmark only triggers a reporting obligation if the so-called "main benefit test" is met in addition. This means whether the main benefit or one of the main benefits of the arrangement is to obtain a tax advantage.

The conditional hallmarks are, amongst others, agreements for performance-related remunerations or confidentiality clauses, the acquisition of loss-making companies, the conversion of income into non-taxable income or income taxable at a lower level as well as transactions with circular transfers of assets.

The mandatory hallmarks that will immediately trigger a reporting obligation are, amongst others, multiple exemptions from double taxation, the transfer of assets with significant differences in the tax value applied and certain transfer pricing arrangements. In addition, the evasion of reporting obligations relating to financial accounts as well as non-transparent chains (masking the identity of the economic beneficiary) are mandatory hallmarks.

WHO HAS TO REPORT AND WHEN?

The primary reporting person is the intermediary who designs the structure. An intermediary is any party that markets cross-border tax-planning arrangements, designs, organises and provides them for use for third parties, or who manages their implementation by third parties, in particular tax consultants, lawyers, auditors or financial services providers. Only in exceptional cases (e.g. if the intermediary is bound by confidentiality or if no intermediary is involved in the arrangement, i.e. an in-house arrangement is created) the primary reporting obligation rests with the user (please note: the EU directive uses the deviating term "relevant taxpayer").

In principle, since 01/07/2020 a reporting must be made within 30 days from the first instance of an event requiring reporting. However, there is a retroactive effect from 25/06/2018. This means that tax-planning arrangements that are subject to reporting, that were first implemented between this point in time and 30/06/2020, must be retroactively reported by 31/08/2020. Due to the corona crisis, the EU has, for the time being, given the Member States the option to extend the deadline for reporting obligations by up to six months. However, it appears that Germany does not intend to implement the extension. A corresponding final

BMF circular was not yet available at the time of this publication.

The tax authorities must be informed of the arrangement in a timely, organised and automated manner. Where a reportable tax-planning arrangement exists, a reporting must first be sent to the Federal Central Tax Office. This usually occurs in two stages. Firstly, the intermediary reports data about the arrangement anonymously. Subsequently, the user communicates his/her specific user data. The tax authorities assign a disclosure number to each reporting received, and a registration number to the tax-planning arrangement reported, which the taxpayer has to declare in his/her tax return.

Any violation of the reporting obligation constitutes an administrative offence. This can be punished with a fine of up to EUR 25,000 per incident. It is currently unclear whether a non-objection period will be granted due to the technical implementation challenges on the part of the Federal Central Tax Office. This will also be stated in the BMF circular which is still pending.

CONCLUSION

Company transactions are often international in character, which means every transaction needs to be checked to see whether it is a reportable event. In this process, not just the transaction itself, but more particularly the post-merger integration phase need to be considered. The review and its results should be documented in detail in order to avoid the risk of a fine in the case of discrepancies.

The identification and reporting of tax-planning arrangements within the deadlines as well as adding the necessary information in the tax return therefore require clear planning and coordination of the audit and reporting process, which should be set up and maintained as part of a tax compliance management system.

We will provide an update on the final provisions regarding deadlines in the next issue of the M&A newsletter.

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→ M&A Vocabulary – Explained by the experts

“Debt Pushdown”

In this ongoing series, a number of different M&A experts from the global offices of Rödl & Partner present an important term from the specialist language of the mergers and acquisitions world, combined with some comments on how it is used. We are not attempting to provide expert legal precision, review linguistic nuances or present an exhaustive definition, but rather to give a basic understanding or refresher of a term and some useful tips from our consultancy practice.

The term “debt pushdown” refers to a series of mechanisms that aim to “push down” a portion of the borrowing taken on by the buyer of a company (or the acquiring company specially set up for this purpose) to the level of the operational target company acquired.

This goal may be driven by tax or financial reasons:

- If the acquiring company and the target company do not form a single tax unit, the borrowing taken on by the acquiring company and the interest expense resulting from this can often not be deducted for tax purposes. Since the acquiring company does not have any operations, and consequently does not generate any significant taxable income, the interest expense cannot be deducted or only partially. In most cases, the operational target company will be paying tax. The corporate tax liability could be reduced if the liabilities were held at the level of the target company rather than the level of the acquiring company;

- from a financial perspective, the liabilities of the acquiring company are structurally subordinate to the repayment of the liabilities of the acquired target company, and are therefore borrowed on less attractive terms than debt financing at the level of the operational target company. The closer a lender is to the assets and the cash flow, the better their lending terms and conditions.

As a rule, a debt pushdown is generally carried out in the form of an extraordinary dividend payment, a repayment of issue premiums or capital reserves, or a reduction in capital. This means that the debt pushdown is restricted in practice by the amount of reserves available for payment of dividends (which must exclude the share capital, the legal reserves, the reserves required by the statutes and revaluation reserves). In order to maximise the level of distributable reserves, the operational target company can opt for a dividend payment from the earnings reserves of its subsidiaries, taking advantage of the parent-subsidiary directive or the parent-subsidiary "box" privilege at its own level, without triggering a significant tax burden. Alternatively, it can also opt for a reduction in the capital of the subsidiaries.

If the companies concerned belong to a single income tax unit, there would be a further option of selling fixed assets between members of the same tax entity. Under French tax law, any capital gains in case of sale generally benefit from deferred tax, for as long as the selling company remains a member of the tax unit, and the sale can be justified in business terms. Under legal systems that do not offer any tax deferral for transfers within a tax unit, and where capital gains in case of sale are taxed normally, then at least the interest costs of the acquiring company can be offset against the capital gains in case of sale.

Debt pushdowns can be challenged using the argument of majority shareholder abuse. From the French point of view, this requires evidence that the decision was made against the interests of the company, with the intention of favouring the majority shareholder to the disadvantage of the interests of minority shareholders.

Therefore, it must be possible to demonstrate that the target company will be able to continue growing despite the increase in its debt, and can repay its liabilities without difficulties. For this reason, we recommend obtaining a credit rating for the target company before carrying out the debt pushdown.

An alternative to the mechanisms mentioned above is the merger of the acquiring company with the target company, a so-called downstream merger. The burden of both interest and capital repayment is transferred to the target company. However, legal and tax problems can also arise in this case, in particular due to the frequent lack of interest on the part of the minority shareholders of the target company.

In practice, in the case of a leveraged buy out (LBO) transaction, a downstream merger like this can generally be proposed only 24 months after the original transaction has been completed.

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