

COMMENTS ON ACQUISITIONS AND MERGERS IN THE COMMON MARKET†

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The following comments deal primarily with tax aspects of acquisitions and mergers in the European Community. Also considered are corporate legal aspects of the problem, both under present laws and as they will be affected by proposed directives of the Common Market. To the extent that British views on these matters have crystallized, they are also covered. Necessarily, the main focus of these remarks is on intra-country and inter-country mergers. First, however, a number of points should be made concerning acquisitions.

I

ACQUISITIONS

A. Tax Aspects

The first question which presents itself to the American firm buying into an existing company is whether it should buy stock or assets. In most EEC countries it would be preferable taxwise to acquire stock rather than assets, although it will be important, as a matter of first instance, for the firm to determine whether the particular type of entity it is buying into can admit corporate shareholders, and if so, the number of shareholders the entity must have to avoid dissolution. While, for the most part, there may be no problem about corporate bodies becoming members of a company, there may be problems if the number of members falls below a required minimum. Problems in this regard can be solved in practice by having nominee shareholders. If the entity involved is other than a company—for example, a partnership or S.A.R.L.—special problems may be presented. Further, a purchase of assets may be the safest way of insulating the purchaser from the past liabilities of the company being purchased. It should be noted, however, that this result may not be achieved in Germany if the acquiring firm chooses to purchase all of the assets of the acquired company. Under German law, the purchaser is liable for past debts. Finally, a firm buying assets may wish to transfer the assets to an existing or newly created subsidiary for the purpose of avoiding the U.S. company's having a taxable permanent establishment in the country where the assets are being acquired.

In making acquisitions in Europe, I think one must consider the tax position

† These remarks were originally delivered at the Duke Institute on the Expansion of the Common Market, April 15, 1972.

The views expressed are solely those of the author and do not necessarily represent the position of TRW, Inc.

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of the sellers as well as his own. It seems to me that many U.S. companies do not anticipate the tax position of the seller, a factor which affects not only the seller's willingness to deal but also the actual costs to the buyer of securing the acquisition. Suffice it to say, both parties' tax positions must be correlated when the transaction is structured.

In the U.K., sellers will likely prefer to dispose of shares, hoping to incur only a capital gains tax charge at thirty per cent. If the shareholders' company sold the business, there would, in the usual case, be a corporate tax of forty per cent on the company on any capital gains realized on the disposal of the business assets, and there would be a capital gains tax charge in the hands of the shareholders to the extent that the net proceeds received in the liquidation exceeded the cost of the shares. Where vendors sell their shares, it is true that the company acquired by the U.S. firm will have built-in capital gains which will be taxable when the assets are subsequently disposed of. This tax charge, however, is deferred. In many cases, there will be no intention to dispose of the fixed assets of the business for a considerable period of time.

Where the U.K. company has been operating at a loss, it might be possible, if shares are transferred, to carry forward those past losses against tax liabilities on profits earned after the change of control. In order to do this, it is essential that there be no major change in the nature or extent of the business carried on by the acquired company for a period of three years. If the assets are acquired, there is no opportunity to carry forward past losses of the selling company.

Where a U.K. business is sold for cash or its shares are sold for cash, there is, of course, no possibility of a deferment of capital gains tax liability or "roll over," and tax will immediately be due. While, from a seller's standpoint, tax-free mergers or acquisitions can be effected through share-for-share transfers, these types of exchanges are infrequent, particularly where U.S. companies are involved as purchasers.

In France an acquisition of stock is normally preferable to the acquisition of assets of an existing company. A capital gains tax would be payable by the company upon sale of its assets. In addition, a registration tax of 16.6 per cent is payable in France on the value of the assets transferred. In view of the untoward tax consequences if a transaction can be viewed as the sale of a going business, an acquisition of stock in France is normally structured in a step transaction. The purchaser initially buys a substantial percentage of the stock, and at a later time purchases the remainder.

Certain other taxes may be applicable to an acquisition of stock in France. If the shares are of a *société anonyme* and the purchase agreement is signed in France, an additional 4.8 per cent registration tax is payable. This tax is normally avoided by having the purchase agreement executed outside France. However, if a business entity other than a *société anonyme* is purchased, there is a 4.8 per cent registration tax payable on the value of the shares or other indicia of ownership which is pur-

chased. This rule applies without regard to where the purchase agreement is executed.

In Belgium a purchase of assets would seldom be made if real estate were involved, unless the liability situation of the company to be purchased was such as to suggest that this was the only prudent course. When assets are purchased, all real estate and all fixed assets—which are deemed as real estate in such a case—would be subject to the 12.5 per cent registration tax on their market value. If the company to be purchased held no real estate, the purchase of assets would, however, be feasible insofar as the tax interests of the purchaser are concerned. The Value Added Tax (VAT) would normally be applied at the rate of eighteen per cent to the purchase price of assets, except for a few cases in which a fourteen per cent rate is applicable. A portion of the VAT is not fully recoverable with respect to purchases of assets made before 1975. However, in the case of the purchase of a whole business or of an entire branch of a business, article 11 of the VAT Code provides for an exemption from the VAT. Thus from the buyer's point of view the acquisition of a Belgian company could reasonably be made by a purchase of assets if no real estate were involved. The only additional tax burden that might arise is the two per cent registration tax payable on the formation of a Belgian company to which these assets might be contributed.

It should be noted that there are no tax advantages for the purchaser in buying assets of a Belgian firm. Furthermore, individual sellers, as opposed to corporate sellers, would pay no Belgian income tax on the capital gains involved in a sale of shares. In the light of tax disadvantages to the sellers in a purchase of assets, a Belgian company would almost always be acquired through a purchase of shares.

In Italy it is also generally true that from a tax standpoint, acquisitions of stock are more beneficial than straightforward acquisitions of assets. The acquisition of Italian stock does not attract levy of any Italian registration tax, while the purchase of assets is taxed at rates ranging from 2.20 per cent if only moveable assets are involved to 11.10 per cent on real estate. Transfers of going concerns comprising both moveables and real estate are taxed at the highest applicable rate. Goodwill, however, is taxed at the moveables rate. Seller and purchaser are jointly and severally liable for the payment of registration tax, and the fiscal authorities are entitled to review the values declared by the parties for assessment purposes. It should be pointed out that while an acquisition of Italian stock is simpler and cheaper, and involves less risk taxwise than an acquisition of assets, some complications may arise from the Exchange Controls in that Italian stock cannot be assigned to nonresidents unless at a value certified to be the fair value thereof by an independent appraisal by the Stockbrokers' Committee of an Italian stock exchange. This aspect, however, may to a certain extent be a matter of negotiation with the banks involved in the currency aspects of a transaction.

In Germany caution dictates against the making of a general statement that for tax purposes, it would be preferable to acquire stock rather than assets. If assets are acquired, the purchaser is in a better tax position because he can write up the

assets and depreciate them at their new value, thus producing a potential savings. When the seller is a corporation, this procedure may not be attractive for the seller because the selling corporation will have to pay its normal income tax on the gain realized by the sale, and subsequently the shareholder will again have to pay taxes either on the dividend income distributed to him or at the time of liquidation. Because the seller thus foregoes the reduced capital gains tax rate in a sale of assets, it is preferable to sell shares. However, the situation may be quite different if the selling corporation operated at a loss in the past so that the gain resulting from the sale of the assets could be applied against the past loss.

In Germany, as is frequently the case, the business being sold may be a partnership. In such a case, the purchase of the partnership shares can offer the purchaser the same tax advantage as if he purchased assets, and the seller will not have a disadvantage since he will still benefit from the reduced capital tax rate.

B. Stock v. Cash Acquisitions

In the past, European sellers have generally registered a decided preference for receiving cash rather than stock of a U.S. company. There may be inherent disadvantages on receipt or use of U.S. stock as, for example, in the U.K. where the seller is subject to a "switch and surrender operation," involving acquisition and surrender of investment currency. Specifically, a resident in the U.K. acquiring U.S. stock has to pay a dollar premium, which at the present time is about 22.5 per cent. When he disposes of this stock, he receives the benefit of whatever the dollar premium is at that date, but he has to surrender twenty-five per cent of this premium to the government. Thus, although he paid the whole of the dollar premium on acquisition, the U.K. resident only receives the benefit of seventy-five per cent of that dollar premium when he sells the shares. Thus, in view of the dollar premium and mechanical problems in holding and disposing of U.S. securities, shareholders in the U.K. usually prefer to take cash.

In France a stock acquisition which amounts to a merger between a French corporation and a foreign corporation may benefit from favorable tax treatment if prior approval is obtained from the Ministry of Finance. Such favorable tax treatment would entail very minimal taxes payable upon the stock-for-stock acquisition. However, I am not acquainted with any case where the French Ministry of Finance has yet approved such a stock acquisition. Nonetheless, an attempt should be made to determine the conditions upon which such an approval might theoretically be granted.

Although a stock-for-stock acquisition is possible from a tax standpoint, French corporate law poses other problems. Pursuant to article 154 of the Law on Commercial Companies, unanimous shareholder approval of a stock-for-stock acquisition would be required. Unanimity would not be required if a treaty concerning such mergers was in effect between France and the other country involved, but there is no such treaty between France and the United States.

In Italy the stock-for-stock acquisition is seldom used. While the assignment of Italian stock to a nonresident would still require the certification as to the fairness of price, the acquisition of non-Italian stock by Italian residents in principle should be authorized by the Italian Monetary authorities.

In Germany, a stock transaction may be feasible. Whenever the acquisition is to be made for stock, the question arises whether this will result in any tax benefits for the seller. The answer is, as a rule, no. The shares are deemed to be cash for determining the tax liability of the seller. Only in exceptional cases can the seller achieve a tax-free exchange of his German shares for American shares. The German Supreme Court for tax matters years ago rendered an opinion on this problem to the effect that the companies whose shares are being exchanged must practically be identical companies in order for the exchange to go untaxed.

In Belgium there is no legal obstacle to a stock-for-stock transaction, and there have been a number of acquisitions of this sort. However, the Belgians have such a strong preference for bearer shares that the U.S. purchaser might well find it difficult to convince the Belgians to accept other securities. This problem can be solved in some cases if the purchaser arranges for the delivery of Bearer Depository Receipts representing the shares of the U.S. company, rather than the shares of the U.S. company themselves.

C. Recent U.S. Accounting Changes

United States accounting principles relating to business combinations and operations apply to U.S. firms on a worldwide basis and, thus, will affect the accounting practices of domestic firms making acquisitions in the EEC. Two principles which warrant attention in the context of the present discussion are Accounting Principles Board Opinion 16 (Business Combinations) and Accounting Principles Board Opinion 17 (Intangibles). Under Accounting Principles Board Opinion 16, an acquisition is considered either a pooling of interests or a purchase. Generally, an acquisition is considered a purchase for accounting purposes if less than ninety per cent of the common stock of a company is acquired in exchange for the common stock of another company or for other consideration. Conversely, the most important criterion for establishing a pooling is acquisition of ninety per cent or more of the voting common stock of a company in exchange for voting common stock of the acquiring company. The accounting results of such combinations are quite different. In a pooling, the balance sheet and profit and loss statements of the two companies are simply combined. In a purchase, however, the purchase price must be allocated to assets and liabilities acquired. The excess of purchase price over net assets acquired is goodwill which must be written off over no more than forty years. Inventory may also be written up and then written down in the year of acquisition, reflecting, in effect, a seller's profit. Fixed and other assets subject to depreciation or amortization are reflected at fair market value. In addition, of course, a purchase usually involves interest costs on money borrowed to make the acquisition. Because of the post-

acquisition charges to the profit and loss statement arising from a purchase, it would appear that pooling, from an accounting viewpoint, may well receive increased attention as a more desirable mode of acquisition in the foreign area, although historically cash (that is, purchase) transactions have been most used by U.S. firms.

Consideration should also be given to Accounting Principles Board Opinion 18. That opinion requires a firm to reflect currently the earnings of companies in which there is twenty per cent or more business interest as distinct from a portfolio-type interest. This rule would, it appears to me, portend increased attention to the current profitability of firms in which a minority interest is acquired by an American company.

II

MERGERS

A. Intra-Country Mergers

1. *Tax Aspects*

As a general rule, it may be said that tax barriers to company expansion within individual countries are not a matter of significant concern. In most instances, there are means of accomplishing a merger within the boundaries of an EEC country without incurring material income taxes. Moreover, the merging firms do not encounter the problem of having more than one national authority taxing a merger transaction. Similarly avoided is the problem of multi-national taxation of distributed profits.

Even if there are no income taxes payable on such mergers, other taxes may apply. In Germany, for example, there is presently an exemption from transfer taxes until January 1, 1973, but the exemption will expire on that date and the transfer taxes which are thereafter imposed may be substantial. In Belgium, a merger of two companies is permitted by means of an increase in the capital of the surviving company with new shares being exchanged for assets of the merged company. There will be a two per cent registration tax applicable to the increase in capital of the surviving company. In Italy a registration tax is imposed on the issuance of new stock, but this can be avoided if certain conditions are met. A similar principle operates within the U.K. While there is an ad valorem stamp duty of one per cent payable on the consideration, exceptions are available in certain circumstances.

2. *Proposed EEC Commission Directive on Joint Stock Corporation Mergers*

There is a proposed directive of the Commission covering the merger of joint stock companies in an individual state. Two types of mergers are dealt with and harmonized. These are mergers involving the absorption of one company by another (acquisition) and mergers in which two or more companies combine into a new company (consolidation). The main purpose of the new directive is to ensure that all interested parties receive adequate information on the important circum-

stances surrounding the merger. It is proposed that the public be informed both of any plans to merge and of the completion of mergers by entry in the register of companies. The boards of the companies are required to make reports explaining the merger plan, and an opinion must be obtained from independent experts on the soundness of the share-exchange ratio.

As the Commission has interpreted article 54 of the Rome Treaty in the directive, the interests of the workers must be protected as well as those of the shareholders. The rights and obligations arising from employment with the acquired company pass on to the acquiring company as part of the transfer of all rights and obligations under the merger. The boards must inform the workers of how the merger will affect them and must consult the Works Council on the matter. The Commission has indicated, however, that the workers cannot block the merger.

In the U.K., particular attention must be given to the rights of the workers. Under the provisions of the Redundancy Payments Act of 1965, employers may be required to make compensation payments to employees who become redundant. Payments are required whether the redundancy arises out of an acquisition for merger or for any similar reason. Redundancy payments are only available to employees who are made redundant by an employer after working continuously for at least two years for that employer. A Central Redundancy Fund, established by the 1965 Act, is financed by contributions from employers, and from it employers who make redundancy payments can recover much of the cost. The precise amount depends upon the age of the employee during the period of employment.

The proposed Commission directive is principally concerned with agreed amalgamations and reconstructions and does not deal with U.K. takeover bids which, as the name implies, many involve a reluctant acquiree. Contested takeover bids are not at all common on European securities markets, and the Commission has in fact indicated that the proposed directive would not cover such acquisitions. Thus it fails to take into account the free and competitive character of the U.K. securities market where contested takeover bids may be quite common. The U.K. has more listed companies than the other members of the Six combined, and the size and vigor of the U.K. securities market exceed those of the Six.

The proposed changes relative to workers, both in merger situations and as later discussed in connection with the proposed European company, indicate that European subsidiaries of U.S. companies may have to be prepared to accommodate a greater voice for workers, especially in those countries of the EEC where worker participation has not reached the structured stage of development existing in France and West Germany. The directive is designed to make sure that all interested parties have information on mergers including the shareholders, workers, and public.

B. Inter-Country Mergers

1. *Tax and Corporate Law Consideration*

Since January 15, 1969, the Council of the EEC, composed of representatives of

member states, has had before it proposed tax harmonization directives designed to facilitate mergers of companies located within different countries of the EEC. Broadly speaking, these are designed, on the one hand, to eliminate tax obstacles preventing mergers from becoming effective and, on the other hand, to create a neutral tax situation for the entire territory of the Common Market in respect of corporate structures resulting from mergers. It is provided that no tax would be levied on inter-country mergers at the time of the merger. These proposals were discussed by the Council at its November 1970 meeting, but to date no action has been taken on them.

Currently there are legal problems under the individual corporation laws of the EEC Six which have to be dealt with in the event of any proposed inter-country merger. Suffice it to say that these laws presently do not adequately provide for statutory consolidations, and international consolidations have taken place primarily through the creation of international holding companies. Simple mergers, involving only the transfer of assets from a company being liquidated in one EEC country to a surviving company in another, will normally result in levy of taxes on the difference between the book value and real value of the assets being transferred by the liquidated company. This has posed a cash problem for companies using this route, with the result that few firms have been attracted to it. A small step has been made, however, by the EEC through a new directive which calls for the harmonization of registration duties at rates between one and two per cent. Upon mergers of companies within the EEC, the registration duties may be reduced by one half.

It seems clear that the adoption of the merger directives will facilitate mergers between EEC countries. Implementation of the proposal will simplify the firm's tax problems enormously and ensure them some benefits. It will, no doubt, encourage Europeans to form larger companies. But, I believe, the direct effect of the directives on most U.S.-owned companies will be more limited. Although the directives may facilitate mergers of the U.S.-owned companies across national boundaries within the EEC, current U.S. tax law may not render such mergers tax-free for U.S. tax purposes. It may be impossible to obtain a favorable U.S. tax ruling; or, if one is received, it may be predicated on a "toll charge" and a closing agreement. The toll charge arises from the requirement that the U.S. company include its share of the post-1962 earnings of its foreign company (that is, the company whose ownership is shifted to another country) in income as a dividend, subject to allowance for foreign taxes paid. A closing agreement triggers deferred taxes on the transaction into income on the happening of certain events such as the selling of merged company's shares.

A U.S. company that wants to enter the European market as a manufacturer can do so by purchasing an existing company or setting up a new operation. Often the U.S. company has capital resources available for this purpose that a European company would not have. Perhaps the only feasible way the European company could expand would be through a merger with a company in another EEC country. A

U.S. company that had no substantial subsidiary in Europe could not usefully avail itself of the merger provisions for the acquisition of an unrelated company. Where a subsidiary is used, there would be the problems of dilution of stock and creation of a minority class of shareholders with no ready market for their shares in addition to the U.S. tax problems alluded to above.

2. *Proposed European Company*

The proposal for a European company is an attempt to remedy the present difficulties involved with inter-country mergers. According to the Confederation of British Industry, the proposal is designed to encourage the concentration of enterprises, presumably only to a degree that is consistent with the preservation of competition, an issue raised in the *Continental Can* proceedings.

This proposal for a European company, which has not been adopted by the Council of Ministers, covers, among other things, mergers between two companies which have headquarters in different member states but which desire to combine across frontiers to form a company under European law. The European company statute contains provisions which protect independent shareholders outside the group and creditors of controlled enterprises within the group. Under the draft proposal there would be a European Works Council, and workers would be given representation on the Supervisory Board. In addition, there are provisions which would make possible a European collective wage agreement. The European Works Council is to consist of representatives from the workers of the various establishments of the European joint stock company elected under the rules applying in the individual countries. Its agreement would be required for decision by the Board of Management in certain specified areas affecting working conditions. Representation on the Supervisory Board is determined according to a ratio of one worker representative for every two shareholder representatives.

It has been said that the European company is the result of a recognition of the dim prospects for sufficient harmonization of company and tax laws in the Six to permit cross-frontier mergers. It should be noted, however, that the European company concept does not attempt to tackle directly the problem of taxes in inter-country mergers. In tax matters the European company comes under the law of the state in which it is actually managed. There can be no tax preference for the European company, and it must be given the same treatment as other companies in the individual states. To provide otherwise might result in competitive distortion.

C. Particular Problems in the U.K.

Some provisions of the proposed European company law, as well as the joint stock corporation directive, differ very substantially from current U.K. practices. These include the use of two-tier Boards of Directors and provisions for employee participation and fixed amounts of minimum share capital.

Three additional items should be mentioned. First, changes in the Exchange

Control Act provide that U.K. firms making direct investments in the EEC countries will, in the future, be permitted to use official exchange or its equivalent up to one million pounds per project in any one year.

Second, England is adopting the Value Added Tax (VAT) system in April, 1973. It has also adopted the imputation system regarding corporations. As a result of the latter change, there will be a single income tax rate applicable to all corporate profits whether distributed or undistributed. Adoption of the VAT will bring Britain in line with EEC practice, while adoption of the imputation system will bring Britain closer to the French tax system.

While it is true that under the imputation system distributed and undistributed profits of companies are taxed at the same rate, the essential feature of the system is the method chosen for assessment. When a company declares a dividend, it must pay a tax provisionally set at $3/7$ of the dividend declared. This tax, known as the advance corporation tax (ACT), may then be credited both by the company against its own corporation tax liability and by the shareholder against his income tax liability. The tax credit will, under present rates, absorb $3/5$ of the company's corporation tax liability and the individual's entire basic tax rate (30%). The shareholder, thus, will only have liability for a surtax and a graduated income tax if his personal circumstances put him in a higher tax bracket. The result of this is, of course, that the present combined tax incidence on distributed profits, on corporation tax in the company, and the income tax and surtax on the entire amount distributed will be considerably minimized for wholly British companies and stockholders. What its effect will be for U.S. controlled British companies and U.S. stockholders requires clarification through treaty adjustments and otherwise.

Finally, on March 21, 1972, a Treasury Order was issued concerning relaxation with respect to Inward Direct Investments by all foreign-owned companies within the special development areas. The Order was intended to remove possible difficulty for those contemplating new investment in these areas. The Order allows foreign-owned companies to borrow sterling in the U.K. for investment in these development areas.

CONCLUSION

Britain starts late in entering the EEC. Some of the patterns of harmonization in the merger area have already been developed. Yet before these patterns are crystallized, the British elements should be considered so that workable solutions can be found which will stand the test of time. Britain will constitute an important element of the Common Market when she joins it on January 1, 1973, and for the good of all parties, her practices must be reflected in Commission solutions to merger problems and other company law matters. Otherwise, the Commission solutions will not be related to the problems at hand. Furthermore, in some areas her traditions and ways of conducting corporate business are more developed than those in others of the Six, and her approaches could be most meaningful in the eventual resolution of inter-country corporate problems.