Taxing Mergers & Acquisitions in Nepal

While the Mergers and Acquisition bring synergy after the merger by creating economics of scale, creating new market, avoiding competition to name a few. The impact of tax on the economics of Mergers and Acquisition transaction may be huge to both the Acquirer and Acquiree Company.

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Introduction

Mergers and Acquisitions (M&A) are transactions in which the ownership of one entity, business organizations or their operating units are transferred to another entity or combined. As an aspect of strategic management, M&A allows enterprises to grow, shrink, change the nature of their business or improve their competitive position.

The term 'Mergers' and 'Acquisitions' are often used interchangeably. However, there are differences. While merger means unification of two into one, acquisition involves one entity buying out another and observing the same. From economic stand point both the Merges and Acquisitions result in the consolidation of assets and liabilities under one entity and the distinction between the both is less clear. Nepal Accounting Standard on Business Combination (NAS 21) calls Seller as 'Acquiree' and Buyer as 'Acquirer'. There are several advantages in M&A – cost cutting, efficient use of resources, acquisition of competence or capability, tax advantage and avoidance of competition are among the few.

Income Tax Act of Nepal does not define the Term 'Merger' and 'Acquisition'. However, it has referred Mergers and Acquisition as the Amalgamation of two or more Companies to become one. Income Tax Act of Nepal refers the term 'Mergers' in Section 47A for the Mergers of entities doing banking or insurance business.

Mergers and Acquisition covers basically three tax aspects, taxability

of assets and liabilities of Acquiree Company, Taxability to the Shareholders of Acquiree Company and the Treatment of assets and liabilities of Acquiree Company in the books of Acquirer Company. In the Nepalese context, Income Tax Act has discouraged the concept of Merger and Acquisition except for the entities doing Banking or Insurance Business.

A. Tax Implication of Mergers and Acquisition of entities doing other than Banking and Finance Business or Insurance Business

While the Mergers and Acquisition bring synergy after the merger by creating economics of scale, creating new market, avoiding competition to name a few. The impact of tax on the economics of Mergers and Acquisition transaction may be huge to both the Acquirer and Acquiree Company.

Tax Implications on the Acquiree Company

There are two basic implications of M&A to the Acquiree Company. First being the tax implication of M&A on Assets and Liabilities of the Acquiree Company and second the tax implication to the shareholders of the Acquiree Company. The question remains whether the Assets and Liabilities being amalgamated to the Acquirer Company constitutes disposal of Assets and Liabilities. If the same is considered disposal than what would be the incoming and outgoing for the purpose of calculating net gain/loss on such disposal of assets and liabilities. Similarly, in case of Shareholder of Acquiree Company, the shareholders will either get cash or shares of Acquirer Company in consideration to their shares held in Acquiree Company and whether such replacement constitute disposal for the purpose of Income Tax Act.

As per Section 40 of Income Tax Act, Sub Section (1), "If the ownership of any person over any property ceases, he shall be deemed to have disposed that property. The disposal of property has to include acts such as distribution of the property by the owner of the property, amalgamation of the property in other property or liability, sale of the property in installments or lease out to any other person under a financial lease, cancellation, destroy, loss, expiration or surrender of the same."

Sub Section (2) "If the burden of liability of any person ceases, he shall be deemed to have disposed that liability. The disposal of liability has to include acts such as settlement, cancellation, release and completion of the liability or amalgamation of liability in other liability or property"

From the above provision, it is clear that in the event of transfer of shares from Acquiree Company to Acquirer Company in any scheme of merger, the assets and liabilities of Acquiree Company is deemed to be disposed off by virtue of Section 40(1) & 40(2) of Income Tax Act. But interestingly Section 41 of Income Tax Act prescribes the manner for the disposal under clauses (c), (d), (e) & (f) of Sub Section 3 of Section 40, however it does not prescribe the manner in which disposal under Section 40(1) and 40(2) has to be done.

There is one view that for the purpose of computation of tax on such disposal under Section 40(1) & 40(2), Market Value of Assets or Liabilities will be considered as Incoming and Net Expenses incurred in such Assets or Liabilities will be considered as outgoing. Such tax should be paid by the Acquiree Company. However, to substantiate such view, there is no any clear provision in the Income Tax Act of Nepal.

The other view which the writer believes is that in the event of disposal of assets and liabilities because of merger, Section 47 of the Income Tax Act Applies. By virtue of Section 47, such assets and liabilities will be disposed off at the Value of Net Expenses incurred for the Assets and Net Income Earning for the Liabilities. Which suggest that the Assets and Liabilities will be disposed at Book Value and there will not be any tax liability on such disposal of assets and liabilities of Acquiree Company.

Taxability to the Shareholders of Merged/ Acquiree Company

Another important aspect in Mergers and Acquisition is the taxability on the Shareholders of the Acquiree Company on the disposal of its shares held in the Acquiree Company. Income Tax Act of Nepal does not have a clear provision as to how the Shareholders of the Acquiree Company will be taxed. In that case, Shareholders of Acquiree Company are left with two alternatives.

Alternative I: As per provision of Section 46(3) read with Rule 16 (1) of Income Tax Rules, "In cases where, by virtue of the unification or restructuring of any entity, the interest of any person in any entity is replaced by another interest of that entity or by the interest of any other entity, an involuntary disposal shall be deemed to have been created." Rule 16(2) provides that "In cases where an involuntary disposal is created pursuant to Sub-rule (1), the entity or person shall submit an application to the Department for an approval" and as per Sub rule (3) The Department may provide approval on the application submitted pursuant to Sub-rule (2).

And in case of involuntary disposal, by virtue of Section 46(1) and 46(2), for the purpose of calculation of gain from disposal of such assets the incoming and net expenses will be equal. Hence the tax base for calculating the tax on such disposal will be nil.

To get the benefit of Section 46, the Tax payer shall submit the application to Inland Revenue Department and it will be applicable, if such application is approved. Now, if the Shareholder of Acquiree Company could not get approval from IRD to invoke Section 46, then there is no clarity as to which section applies.

Alternative II: The Author believes that in case approval from IRD under section 46(3) rule 16 is not available or in general case of merger, taxability to the shareholders of the Acquiree Company can be addressed through Section 47 of Income Tax Act of Nepal "**Disposal upon amalgamation of property and liability**". As per Section 47 of Income Tax Act, If, as a result of acquisition of any property or bearing of any liability by any person, any other property under ownership of, or any other liability borne by, that person ceases or is amalgamated and thus disposal takes places, then the following provisions shall apply:-

(a) Where net expenses were incurred for the amalgamated property or liability immediately before disposal, that person:

   (1) Shall be deemed to have received an amount equal to the net expenses in respect of the disposal of the amalgamated property or liability, provided that, such amount shall not exceed the amount received by that person for the amalgamated liability.

   (2) Shall be deemed to have incurred expenses in a sum equal to that amount in holding ownership or bearing liability of the amalgamated property.

(b) Where net incomes were earned for the amalgamated liability in respect of the amalgamated liability, immediately before the disposal of the liability, that person:

   (1) Shall be deemed to have incurred expenses in a sum equal to net incomes for the disposal of the amalgamated liability, provided that, in the case of the amalgamated property, that amount shall not exceed the amount spent by that person in acquiring that property.

   (2) Shall be deemed to have received an amount equal to that amount in holding ownership of or bearing liability of the amalgamated property.

Hence, there will be any tax effect on the Shareholder of the Acquiree Company as the Net Expenses incurred by him will be both Incoming and Outgoing for the purpose of calculating the gain on disposal of his shares.

Taxability to the Merged/Acquirer Company

From the Acquirers perspective, there are two important aspects to be considered while doing mergers and acquisition transaction. First being the Cost base of Assets and Liabilities being transferred to the Acquirer Company from the Acquiree Company and second being the Tax benefits being provided to the Acquirer Company.

Cost base of Assets and Liabilities of Acquiree Company being transferred to the Acquirer Company will depends upon the Value at which such Assets and Liabilities are transferred. If we assume that such Assets and Liabilities are disposed off at Market Value than the Market Value would be the Cost base to the Acquirer Company. But such Assets and Liabilities will be booked at Book Value in the Books of Acquirer Company, if we believe the premise that Section 47 is applicable and such Assets and Liabilities are transferred at Book Value.

Further Section 57 of the Income Tax Act is attracted if the Merger changes more than 50 percent shareholding of the company within a block of 3 Year. As per Section 57(1) of Income Tax Act, "If the ownership of any entity changes by Fifty per cent or more as compared to its ownership until before the last three years, the entity shall be deemed to have disposed the property under its ownership or the liability borne by it." And by virtue of Section 40(3)(E) and Section 41, All the Assets and Liabilities of the Acquirer Company will deem to have been disposed off at the Market Value. Thereby Tax on Disposal of Assets and Liabilities has to be paid on the difference between the Market Value and the Book Value of the Assets and Liabilities.

Further Section 57(2) provides that where more than 50 percent shareholding is changed, following will be the implications for the Acquirer Company:

- The unabsorbed portion of interest carried from previous period as per Section 14(3) is not allowed to set off.
- Losses Carried Forward from previous Years as per Section 20 will not be allowed to set off and carry forward to further years.
- Any adjustment as provided by sec. 25(1) for an amount derived on an accrual basis, the person later disclaims an entitlement to receive the amount or, in the case where the amount constitutes a debt claim of the person, the person write-off the debt as bad, is also not allowed in case it occurs after the change in ownership.
- To subtract, pursuant to Section 36, the loss suffered in disposing any property or liability prior to the change in ownership from the income earned from the disposal of the property or liability after the change in ownership is now allowed.
- In case where the entity accounted for a premium in terms of section 60(2)(b)(1) prior to the change and the entity after that change returns the premium to the insured, such premium is not allowed as expense.
- Carry forward of foreign income tax under section 71(3) that is paid with respect to foreign income prior to the change is also not allowed

Further as per Section 57(3), In cases where the ownership of any entity changes in any manner mentioned in Section 57(1) in any income year, the parts before and after the change in ownership in that income year shall be treated as separate income years. And income tax returns for such separate periods needs to be submitted.

B. Special Provision in case of Mergers and Acquisition of Entities doing Banking and Finance Business or Insurance Business

Income Tax Act of Nepal has formally acknowledged the importance of Tax Benefit in the Mergers and Acquisition with the Finance Bill 2067 that too only for the Entities carrying on Banking and Finance Business or Insurance business by inserting Section 47A.

As per the Section 47A of Income Tax Act- "If entities of similar nature carrying on banking and financial business or insurance business are merged to each other, provisions of Clauses (a), (b), (d), (e), (f) and (g) of Sub-section (2) of Section 57 and Sub-section (3) thereof shall not apply."

Provided that, if there is any loss that could not be deducted of any entity that ceased to exist upon merger, such loss has to be deducted in the coming Seven years on pro rata basis. If the entity that so deducts loss by equal installments is again divided prior to the deduction of loss wholly, tax on the amount deducted for the deducted loss has to be paid at the rate of tax prevailing in the financial year of merger or acquisition.

Taxability to the Acquiree Company

In the case of merger of entities doing banking or insurance Business, Income Tax Act vide Section 47A(2) has prescribed manner in which the Assets and Liabilities of Acquiree Company shall disposed off. It provides that If the disposal of assets and liability is made upon the merger of entities pursuant to Sub-section (1), the following shall apply:

(a) In the case of disposal of trade-in-stock and business property:

    (1) The amount equal to the net expenses incurred in that property immediately before the disposal shall be deemed to have been acquired by that person in consideration for that disposal, and

    (2) The amount equal to that set forth in Clause (1) shall be deemed to be cost incurred by the person acquiring the property.

(b) In the case of disposal of depreciable property:

    (1) The amount equal to the remaining value of the diminishing system of the group pursuant to Section 4 of Schedule-2 at the time of disposal shall be deemed to have been acquired in consideration for that disposal, and

    (2) The amount equal to that set forth in Clause (1) shall be deemed to be the cost incurred by the person acquiring the property.

(c) In the case of disposal of liability:

    (1) The amount equal to that amount whichever is lesser out of the market value of the liability and the net income immediately before the disposal shall be deemed to be the cost incurred by that person in consideration for disposal.

    (2) The amount equal to that set forth in Clause (1) shall be deemed to be the cost incurred by the person bearing liability in consideration having borne that liability.

(d) In calculating the cost of merged assets and liabilities, the entity merging business or the entity merged shall calculate only the cost in consideration for assets and liability existed at the time of operation of the merged business by the merged entity (prior to merger or acquisition), pursuant to Clauses (a), (b) and (c).

In case of merger of entities doing banking or insurance business, Section 47A clearly provided that the Assets of Liabilities of Acquiree Company will be disposed off at Book Value and hence there will not any tax liability on such disposal.

Other Benefits provided

Section 47A has provided following other benefits for the mergers of entities doing banking or insurance business.

- As per Section 47A(3) Tax deduction shall be made on the payment by giving Fifty percent rebate on the rate of tax deduction to be applied on the retirement pension on the additional lump sum payment (except the payment made through

the retirement fund or the payment to be made as mentioned in the terms and conditions of employees for the purposes of awarding group retirement to the employees serving in the entity disposed upon merger or the entity following merger).

- As per Section 47A(4) The shareholders existing in the entity disposed upon merger pursuant to Section 47A(1) dispose their shares by sale within Two years after the merger, no capital gain tax shall be charged on the profits made on the shares so disposed.
- Further Section 47A(5) provides that Tax shall not be levied on the dividends distributed by the entity that has been disposed upon being merged to the shareholders existing at the time of merger within Two years after the date of merger.

However, to get the benefits of Section 47A the entity that intends to be disposed upon being merger shall give a letter of intent to be merged to the Inland Revenue Department within the time prescribed under section 47A(6) and it shall complete such merger within the time prescribed by Section 47A(7).

C. Issues to be noted

From the above provisions of the Income Tax Act, we understand that the Income Tax Act is not very clear with respect to the Taxability of assets and liabilities and the Quantification of gain/loss from the disposal of assets and liabilities of Acquiree Company not being entity doing banking or insurance business. Further in both the cases whether it is the entity doing banking or insurance business or otherwise, taxability on the disposal of shares of shareholder of Acquiree Company is also not very clear.

Similarly, Taxability on the Disposal of Assets and Liabilities as per Section 57 is something which is very detrimental to the promotion of mergers and acquisition transaction in Nepal. There are two reasons behind this first being by virtue of Section 41(1), Disposal of Assets and Liabilities under Section 57 will be taxed at Market Value less Book Value of Assets/Liabilities, second it will be taxed to the Company not shareholders. This way tax will be levied to both shareholders on the gain on disposal of their shares and to the company for its deemed disposal under Section 57. Taxing Shareholder could be logical, however taxing company under Section 57 where there is no real benefit to the company is not very logical. Section 57 of Income Tax Act of Nepal is similar to the Income Tax Provisions of other South Asia countries for disallowing carry forward of losses in case of change in control. The real intent of Section 57 is just to stop the tax payers to take benefit of carry forward of loss by unreasonable means but not to tax the company in which such change of control happens. More importantly its implication is really huge as it applies even in case of inviting introduction of new shareholders, venture capital firms or even in case of increase in share capital.

D. The Way Forward

With the Globalization, Multinational Companies are dominating every part of the world, and to stay in the ring Domestic Companies need to grow. Hence, it is very important to promote mergers by the government to promote the Domestic Companies to compete with global firms. With the current tax legislations on the Mergers and Acquisitions, it would be very difficult for us to see any Mergers and Acquisitions happening in the Industries other than Banking and Insurance in future. Among other tax reforms required, Nepal needs a better Capital Gain Regime to promote both the Mergers/Acquisition and Foreign Investments. Government need to take a call in this.