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M&A Integration and Indirect Tax: Managing the Moving Parts Before, During, and After a Transaction

BY RICHARD CORNELISSE

With indirect taxes intertwining through the day-to-day operations of a company—raising sales invoices, moving inventory, paying suppliers, collecting cash—indirect tax risk can have a distinct and domino-like effect on the commerciality of an organization.

The impact can increase exponentially in the event of a merger or acquisition. But do these taxes and tax planning opportunities get the attention they need, especially in light of increasingly complicated and globalized business models?

In a simpler time, due diligence for the purchaser typically focused on identifying, assessing, and quantifying historical indirect risks. The aim was to provide insight into these risks and build into the contract adequate coverage in case (risk) history repeated itself. Armed with this information, the buyer could negotiate a reduction of the selling price or secure indemnification from the identified risk.

The tax advisory input also would extend to opportunities inherent in the deal structure. With effective planning, deal costs would cascade down the group to sit in an appropriate entity for commercial and corporate income tax deduction purposes, and value-added tax would not ''stick'' as an unrecoverable cost—at a rate of up to 25 percent in the European Union.

Asset deals are less rigorously subject to tax due diligence: The historical risk usually remains with the seller and the buyer takes on only the risks directly associated with the assets. In cases where all the assets qualify as a business going concern, the transfer might not be subject to VAT. The seller would not have to charge and report VAT, the buyer would not have to pay or deduct VAT, and both parties could see a cash flow advantage.

Richard Cornelisse is with Global Indirect Tax Management, Ernst & Young LLP.

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Transactions in Today's Business World

Even as the world is shrinking, businesses and their growth strategies are becoming more complicated. A schematic drawing of the functions of a typical multinational today might look like a Rube Goldberg contraption—a complex of moving parts that must connect one to another for tax, regulatory, and reporting purposes.

And unlike the more contained structure for handling income-based taxes, responsibilities and key drivers for indirect taxes may be spread throughout the enterprise, residing not just in the tax department but in any of such diverse departments as finance, information technology, supply chain management and logistics, human resources, and beyond.

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Added is the growing trend toward shared service centers (SSCs) that are responsible for operational processes including accounts payable and accounts receivable as well as other outsourced functions for tax, finance, and treasury. Tax determination and reporting for the entire operation may be governed by one or more enterprise resource planning systems, which in turn may be integrated to varying degrees, with or without the benefit of sophisticated technology tools.

All these factors make for a changing and increasingly sophisticated business environment that requires a different approach to business indirect tax advice. Al-

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though fundamental tax due diligence is still a requirement for the purchase of a company or assets, it is only the opening chapter. Equally important are exploring and thinking through options for structuring the indirect tax profile and how it will function in the organization post acquisition and throughout implementation and integration.

A Look at Some Critical Questions

Asking the critical questions—whether of outside advisers or company leadership—can help focus on the relevant issues in these areas of particular importance.

Processes and Controls, History and Knowledge

- What are the new processes and controls going to be?
- Who owns these controls?
- Will the tax knowledge of the acquired business be retained or will there be key staff resignations?
- What technology will be retained?
- Who is aware of the tax planning history and can help make sure that the proper structures are maintained?
- How will the seller's processes and systems be integrated?

The New Structure and VAT

- Should VAT be charged on the sale? If so, what country's VAT should be applied and at what rate?
- Who is liable for any VAT chargeable, and if chargeable can this be deducted?
- Who is responsible for VAT errors and penalties?
- How will inventory be integrated into the new purchaser's supply chain?
- Will using a classic principal structure in the new entity help keep maximum profits in low-tax jurisdictions? If so, one entity will own title to inventory throughout the various jurisdictions and the principal would require a VAT registration in each location where inventory is held.
- Where will the regional inventory hubs be located? Careful planning of the hub locations will allow VAT on import to be deferred to a point where it no longer represents a cash flow cost to the business. Conversely, poorly implemented ''virtual'' VAT inventory systems can have the opposite effect: With each national entity able to move its own goods to a foreign jurisdiction, ostensibly to maintain a minimal level throughout the region, the actual result could be that every national subsidiary would require a VAT registration in every other European jurisdiction.
- Are U.S. foreign tax credits to be used with transactions occurring outside the United States? A VAT registration is generally needed where inventory is held. In some countries, particularly those in Asia and Latin America, a VAT registration will crystallize a permanent establishment for corporate income tax purposes. This would mean a massive increase in the U.S. corporation's foreign tax compliance obligation and could substantially increase the amount of tax due as well as the workload.
- Where will the deal costs sit? Deal costs are generally cascaded so that the corporate income tax deduction can be taken at the appropriate entity. But when the cost remains in a holding company, VAT will be an absolute cost to the transaction.

What Happens to VAT When the Business Model Changes?

A change in the business model can actually create VAT risks. For example, the selling arrangement may change from a buy/sell to broker/agent or vice versa. Goods purchasing may become centralized. The flows and storage locations of goods may change.

In any of these cases, new VAT registration obligations may be created in different countries. Likewise, VAT could be chargeable by different entities and the recoverability of the VAT could change, and different billing flows are created.

Accounts Payable/Accounts Receivable

As the acquisition integration continues, something as basic as a billing error leading to invoices issued in the wrong name could not only delay revenue receipt but also result in nonrecoverable VAT. The penalties for incorrect invoicing can be a percentage of the turnover, so amounts can quickly become material—up to 25 percent VAT in Europe on the turnover plus penalties.

Intangible Assets

One of the fundamental questions to answer is where the ownership of intangible assets will sit in the new structure and whether it will be migrated to a low-tax jurisdiction. We have seen VAT charged on the sale of intangible assets from one U.S. corporation to another because the assets were exploited in Europe and the acquiring company had not planned ahead to assure proper registrations were in place.

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In one case, VAT was not recoverable and the company incurred an unexpected cost to the transaction of about 20 percent of the value of the intangible asset. This is a prime example of relying on due diligence from a historical perspective. If intangibles were not an issue before, the historical risk would not show up but the current and future risk would loom large.

Look in the 'I's

As anyone who has lived through the M&A experience knows, there are a number of moving parts relative to indirect tax. It is not uncommon for some things to be overlooked or under-planned. But when that happens, serious and material consequences can occur, substantially affecting the cost as well as the ultimate success of the transaction.

Implementation

Once a commercial and tax-efficient structure is determined—one that addresses both historical and potential risk—it is time to take the theory behind the structure into the realm of practice.

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Who is taking care of filing VAT registrations? When should you apply for VAT registration, since average lead times in jurisdictions can be several months? Who is responsible for maintaining a structure and making sure the business is acting in accordance with the model? How is this communicated throughout the organization? How will ongoing monitoring be handled?

Most ERP systems, including SAP, Oracle, JD Edwards, and Peoplesoft, are equipped with some form or forms of VAT functionality. However, they typically still require significant configuration and may need to be customized to deal properly with indirect taxes. They will also need to be updated and tested to reflect new contracts and billing flows. Ownership of these tasks must be determined and communicated up front, so that the ERP system can accurately issue invoices from day one.

Integration

The next stage involves integrating the legacy business into the new business if possible, or devising a hybrid model through which the two legacy systems run side by side. Although a fully integrated system is more likely to yield greater economies of scale, tax knowledge continuity is critical to managing risks in either case.

The continuity includes others outside the tax arena—the logistics team who understands the physical shipments and flow of goods and would complete and submit customs declarations; the shared service center clerks who actually create the sales invoices; the IT team who manages data sharing between different systems.

Impact

The impact we are talking about here is largely concerned with potential problems and cautionary tales. What if VAT registration is not obtained on time? The ERP system is not tested or updated? There is no central ownership of key processes? Appropriate project team participants do not understand the material impact of indirect tax?

The results of these gaps in practical application can range from logistical problems (customs not allowing goods to clear in a country) to invoicing errors (invoices needing to be redone and cash collections delayed), from incorrect tax treatment on transactions to difficulties in VAT compliance that can result in payment and reporting errors and penalties.

Interim Solutions and Workarounds

When the new business model cannot be implemented into the purchaser's own ERP system within a given time frame, the typical solution is to temporarily outsource the process to the seller through a temporary service agreement. But such workarounds, however practical, can lead to new risks.

In an asset deal, for example, an ongoing relationship with the seller as part of the transition agreement could be seen as outsourcing VAT accounts payable/accounts receivable processes. That in turn could trigger VAT compliance issues, difficulties in accessing data, questions around the quality of VAT controls, and blind reliance on an ERP set up with an outcome that could not be verified.

There are possible people issues as well. Although the vendor's (seller's) staff and systems are used to bridge the gap until the necessary resources, knowledge, systems, registrations, and authorizations are in place, the people doing the work have no real vested interest in the new model. In fact, they may even be losing their jobs because of the merger or acquisition.

Invoicing in the Interim

In worst case scenarios, staff members may not feel responsible for the work they are doing. We have seen results that, if not costly and catastrophic, certainly undermine the functionality and credibility of the enterprise.

One of the most common side effects of an integration that cannot be fully realized surfaces in the realm of invoicing. For example, large numbers of payable invoices are not correctly coded so VAT is not deductible. Or when the legacy system is only half integrated into the new model, incorrect sales invoices are issued, causing problems for customers, incorrect reporting of tax figures, and missed compliance obligations.

Knowing who is legally obliged and practically able to issue invoices is critical in interim or transitional situations. Is the previous owner legally allowed to issue invoices? Whose VAT compliance issues are these and how can the new owner obtain and share information? Can the new company continue billing its customers? Implementing a transitional arrangement—especially if it is unplanned—can be expensive, causing delays to the overall integration and setting practical, commercial risks into motion.

An Indirect Tax and Acquisition Checklist

Indirect tax risks are prevalent throughout the entire M&A and integration process. Here are some of the leading practices, lessons learned, and perspectives to keep in mind so that they do not become stumbling blocks:

- Set up a project charter that will take effect as of the very first due diligence activities.
- Validate due diligence findings and define priorities.
- Make an indirect tax integration plan and ensure that the right sponsors provide buy-in.
- Map out the current state upon acquisition and identify key risk areas, opportunities, and people in the organization acquired.
- Jointly validate and refine the integration plan and develop a road map to success.

A relevant indirect tax strategy—correctly implemented—will allow the new business to function effectively from go-live, from both a tax and commercial perspective, so that it can move inventory, generate sales and invoices, face fewer disputes with non-paying customers, remain tax compliant, and integrate the business on time and on budget.