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TALKING TAX - Issues arising from M&A transactions

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One important aspect of mergers and acquisitions is knowing to what degree a company or companies being acquired have been responsible taxpayers and done their best to comply with tax laws.

Latvian tax authorities can audit a corporate taxpayer up to three years after the final date for tax payments in a particular tax year. If they find inaccurate accounting, criminal penalties can ensue. Accordingly, a foreign or local company that has merged or acquired a Latvian company will eventually, as the new owner, become liable for any tax problems that existed in the target company over the previous three years.

As part of the overall due diligence process, a taxation due diligence can also be performed. If there are a number of target companies involved in transactions not limited to Latvia but also on an international basis with related entities, unrelated entities or entities located in “offshore jurisdictions,” a tax analysis becomes even more important and complex.

For instance, if transactions that do not comply with tax laws are identified, an estimate of unpaid taxes is compiled, together with potential penalties, so the purchaser is aware of these possible future risks in the event of a tax audit. The size of these risks may or may not stop the purchase from going ahead, or alternatively, can be included as a warrant or indemnities in the final purchase agreement. They can also be subject for discussions during finalization of the purchase price.

Tax optimization. A second important effect of taxation in an M&A is planning for future taxes and how best to legally minimize them. Future cash flows between the parent and subsidiary company or companies in the group must be planned so as to obtain the greatest cash flow and return with the minimum taxation cost.
Thus a transaction must be examined to determine which finance method or mix of financing methods, using debt or equity finance, will meet the dual goals of generating greatest cash flow and return with minimum tax expense.

With debt financing, the acquisition structure needs to be planned so that when interest is paid withholding taxes are minimized and the maximum deduction is obtained for interest deductions by not exceeding any thin capitalization rules. With equity financing, the main issue is limiting the imposition of the dividend withholding tax on dividends paid and also obtaining the maximum tax credit for withholding tax paid (the latter is relevant also for interest withholding tax).

In a merger and acquisition transaction the discovery of potential historical taxation liabilities and the planned minimization of future taxation liabilities often prove to be necessary and important exercises.

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