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How New EU Tax And Transfer Pricing Rules May Affect M&A

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This article discusses new and proposed European tax rules up to 2025, as well as recent transfer pricing rules, that have a far-reaching effect on mergers and acquisitions.

In particular, the European Union's Anti-Tax Avoidance Directive, or ATAD, and the minimum tax rules resulting from the introduction on Jan. 1 of Pillar Two, also known as the global anti-base erosion rules, may raise red flags during due diligence. They therefore deserve to be carefully analyzed.[1]

A fiscal due diligence should also include consideration of risks and opportunities from a transfer pricing perspective. These will be discussed based on the guidance published in the Organization for Economic Cooperation and Development's 2022 transfer pricing guidelines.

EU Tax Developments

Anti-Tax Avoidance Directives

As a result of ATAD, EU member states have introduced measures aimed at erosion of the local tax base.

ATAD1, broadly implemented by most EU member states since 2019, concerns, among other things, a limitation on interest deductions, the introduction of a controlled foreign company rule, a general anti-abuse rule, and an exit tax on cross-border transfers of assets.

ATAD2 focuses on so-called hybrid mismatches that result in negative tax results — such as double nontax or deduction, or no inclusion — and has been implemented by EU member states since 2021.[2]

ATAD2 covers a number of hybrid mismatches. A hybrid mismatch may appear in various forms, including hybrid entities and hybrid financial instruments.[3]

ATAD3 is the so-called unshell directive, and is a proposal by the European Commission for a council directive aimed at EU-based entities that lack a minimum of economic substance. If an entity is identified as a shell entity, it may not be able to obtain a tax-residence certificate, and therefore not benefit from tax treaties and other tax facilities such as the participation exemption.

Furthermore, the tax authorities could share its information with other EU member states through the automatic exchange system, and the shareholder could become liable to pay tax on the shell entity's results under the controlled foreign company scheme.

The proposed effective date of ATAD3 has been postponed to Jan. 1, 2025.

In particular, ATAD1's cap on interest deductions can negatively impact financing costs and company valuations, potentially killing an otherwise successful deal if not managed sensibly.

Since 2019, the European member states have introduced a limitation on the interest deduction —

including costs and currency results — meaning that intercompany and third-party interest is no longer deductible if and insofar as interest (1) exceeds 30% of earnings before interest, taxes, depreciation and amortization, or EBITDA; and (2) exceeds the maximum EU threshold of €3 million ($3.25 million).[4]

Pillar Two

Pillar Two is one of the two pillars of the OECD-G20 inclusive framework to reform the international tax system.[5] Pillar Two introduces a global minimum tax of 15% for multinational companies with a turnover of more than €750 million in two of the last four years.

The EU and a growing number of other jurisdictions have implemented Pillar Two in their legislation from 2024.[6]

OECD Transfer Pricing Guidelines

In recent years, the OECD transfer pricing guidelines have introduced new clarifications in the area of financial transactions, i.e., determining arm's-length terms for guarantees, intercompany loans, cash pools and captive insurance.

Particularly important is the topic of "control over risk," which determines who is entitled to the proceeds of a financial transaction.

Identification of Tax and Transfer Pricing Risks Through Due Diligence

ATAD1

As the ATAD1 measures have been largely implemented in the national legislation of the EU member states, special attention should be paid to the financial statements of the acquisition target within the due diligence process. After all, if an entity has a lot of debt on its balance sheet, it should also have sufficient profit capacity to be able to fully deduct the interest owed, let alone foreseeable losses. This immediately raises interesting related issues now that many European countries have limited their options for loss settlement.[7]

The interest-deduction restriction could come as a double whammy for the company in situations where interest rates rise and EBITDA falls due to market conditions.

Such a situation may ultimately require an acquiring company to deploy more equity in the financing mix, resulting in a higher weighted average cost of capital, which could in turn result in a lower valuation of the acquisition target. And with less interest to be paid, dividend payments may increase, which in some cases may result in more dividend withholding tax.

ATAD2

Attention should be paid to situations of double deduction.

In order to neutralize double-deduction mismatches, the directive includes a primary rule stating that the deduction of a payment is disallowed in the payer's state; as a secondary rule, it states that the payment is included in the recipient's taxable income.

It may happen that one country considers a company to be transparent, while another country considers the same company to be nontransparent. This causes problems if, according to the legislation of country A, the underlying participants should be taxed in country B, while according to the legislation of country B, the independent company should be taxed in country A — the ultimate result being that no tax is levied anywhere.

A financial instrument mismatch is one of the other mismatches covered by the directive. An example is an upward adjustment of interest or acquisition price by paying party C, in order to bring the pricing to arm's-length levels, that is not followed by receiving party D.

This unilateral adjustment is a mismatch as there is a "minus" in the tax return of party C without a

corresponding "plus" in the tax return of counterparty D.[8] Hence, party C will be denied the adjustment.

Another example of a financial instrument mismatch is a so-called Dutch participation loan that is legally requalified as equity for Dutch tax purposes, but that still may be considered a loan in the other country, resulting in different tax treatment.[9]

Under certain circumstances, though, restructuring may still be completed without the adverse consequences of this anti-tax-abuse legislation.

ATAD3 Unshell Directive

The directive introduces a series of gateway tests to identify high-risk or so-called shell entities. These tests assess factors such as sources of income, cross-border transactions and management arrangements.

Some tests are based on the entity's revenues and activities over the past two years, so due diligence should include examination of a company's position in the period since Jan. 1, 2022.[10]

Attention should be given to companies that could be affected, i.e., companies with foreign investments, private equity funds with tiered ownership structures, companies with mobile or passive income — such as interest, dividends, royalties or rental income — generated from cross-border activities or passed on to foreign entities, and entities with outsourced directors, administrative operations or decision making on important functions.

Pillar Two

For Pillar Two, if multiple acquisitions are considered, e.g. to attain a sizable platform, the turnover limit of €750 million can play a crucial role.

In that case, particular attention should be paid to low-tax jurisdictions or entities with tax benefits, such as research and development facilities and the like. Under such circumstances, claiming such tax benefits over several years could be considered.

Transfer Pricing

If tax or transfer pricing risks arise during due diligence, their potential impact on expected cash flows should be determined by assessing the financial impact of the subsequent profit adjustments, including late-payment interest and potential penalties.

An uncertain tax position may have to be disclosed in a company's annual accounts — and in several countries, proactively to the tax authorities as well — due to incorrect transfer pricing in previous years.

Even if the acquirer is indemnified for tax damages, the time and money spent resolving disputes and dealing with the relevant authorities may not be fully compensated. In addition, a correct transfer-pricing model could lead to a different allocation of profits, leading to a higher effective tax rate and fewer options for loss compensation.

Failure to take this into account could lead to a flawed valuation model, an inadequate risk profile and subsequent funding issues.

Especially where local interest obligations are no longer in line with the new arm's-length allocation of local profits, it is possible that interest payments will not be fully deductible and free cash flow will fall. As a result, debt covenants may come under pressure and the financing mix — debt/equity — should be reconsidered.

Other transfer pricing risks may include the following.

- The prices for the provision of intercompany products or services are not at arm's length.

- There is a discrepancy between the legal intercompany agreements and the actual conduct within the company.

- There is a discrepancy between the legal owner of the intellectual property and the allocation of the development, improvement, maintenance, protection and exploitation functions related to that IP.[11]

- A restructuring has taken place where assets, functions and risks were transferred to other group entities without an agreement on arm's-length compensation for the transfer.

- Contemporaneous transfer pricing documentation is unavailable, creating the risk of incorrect transfer pricing, reversal of the burden of proof, additional tax assessments, double taxation, fines and late-payment interest.

- High-interest shareholder loans have been provided where the interest or default risk is not in line with the arm's-length principle; as a result, part of the loan could be treated as a capital contribution, while the related interest payments are not deductible.

- A group entity functions as a financial intermediary without full control over risk with regard to financial transactions; the risk here is that a write-off of the intercompany loan will be denied, although the interest received should be included in the taxable profit of another entity that has control over risk.

Planning for the Future When Structuring a Deal

If the tax and transfer pricing risks are correctly identified during the due diligence phase, it offers opportunities to properly structure the takeover and negotiate the best financial terms of the acquisition.

During a private equity acquisition, a loan is typically provided by the investor to an acquisition holding company. This loan can be pushed down and serviced by the acquisition target, which pays the interest from its business earnings.

Before the introduction of the generic interest limitation rule, interest payments were fully deductible, and group companies were often part of one fiscal unity per jurisdiction, which meant that revenues and costs could be offset against each other in one consolidated tax return.

The generic interest limitation rule generally allows the EU threshold of up to €3 million to be used multiple times in one country, provided that each entity files its own tax return.[12] Partly for this reason, it may be beneficial to have each local entity obtain its own loan for working capital in order to optimize the group's interest deduction, instead of raising loans centrally.

Ideally, each entity will have sufficient profit capacity to fully pay off the interest payments on its loan.[13]

Conclusion

Given the value-driven motives behind an M&A transaction and the subsequent strong efforts to successfully complete the transaction, tax and transfer pricing risks are often overlooked.

Now that many business models have been integrated globally and tax authorities within the EU have been given more means of oversight as a result of ATAD, Pillar2 and the OECD's latest transfer pricing guidance, the scale of tax and transfer pricing risks has increased significantly.

ATAD's limitation of interest deduction in particular can have an impact on the total debt/equity mix, and therefore on the weighted average cost of capital. This can affect valuations and ultimately lead to a deal failure if the necessary financing cannot be secured.

A structured approach to tax and transfer pricing by the M&A lead manager includes better tax and transfer pricing risk management, as well as opportunities for greater tax and operational efficiency.

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[1] Two other recent proposals for an EU Council Directive with an impact on M&A are the debt/equity bias reduction, or DEBRA, which gives shares the same tax treatment as debts and Business in Europe: Framework for Taxation, or BEFIT, referring to a common corporate tax base that would lead to a different distribution of tax rights within the EU. For the purposes of this article, we will not discuss these proposals.

[2] The reverse hybrid rule is applicable in most EU member states since 2022 with some EU countries applying this rule from 2019-2021 already.

[3] For the sake of completeness, hybrid mismatches can also occur in the form of a hybrid transfer, a hybrid permanent establishment, an imported mismatch, double deduction and a double place of residence.

[4] These threshold amounts differ per country and are considerably lower in France, Netherlands, Poland, Portugal, Romania, Sweden and Spain.

[5] Pillar Two or global anti-base erosion, or GloBE, consists of an income inclusion rule and an under-taxed payments rule. Under the income inclusion rule, multinationals are required to pay an additional tax if a jurisdiction's effective tax rate is lower than 15%. The under-taxed payments rule is a secondary mechanism for additional assessment in the case of nonparticipating jurisdictions. Pillar Two purposes require the submission of substantial new forms containing financial data that tax authorities may not currently have access to.

[6] Under the OECD's inclusive framework, more than 140 countries agreed to enact a two-pillar solution to address the challenges arising from the digitalization of the economy.

[7] In the Netherlands, loss settlement is unlimited in time. However, the offset of losses above the €1 million threshold is limited to a maximum of 50% of taxable profit in a given year. This applies to losses suffered after 2019. For losses incurred before 2019, the old rules remain in force, whereby losses are fully deductible and unlimited in time.

[8] If the application of the at arm's-length principle leads to a higher transfer price, the book value of an asset can only be increased by party A to the extent that the higher transfer price is added to the book value of party B.

[9] A participation loan is a loan that "actually functions as equity" and as such needs to meet three cumulative conditions: (1) the loan's interest percentage is profit-dependent; (2) the loan is subordinated; and (3) the loan has no fixed term.

[10] The intended effective date was initially 2024 with a reference period to 2022. Now the effective date has changed to 2025, the EU parliament has decided to recommend keeping 2022 as the reference period for examination of the gateways. However, it is still possible that some easing in

terms of timing may be provided by the EU Commission at a later stage.

[11] The allocation of revenues (and costs) from intangible assets should be achieved by remunerating members of the multinational enterprise group for the functions performed, and the assets used, and the risks assumed in the development, improvement, maintenance, protection and exploitation of intangible assets.

[12] Deviating rules may apply per EU jurisdiction and should be analyzed.

[13] When allocating the loan-interest charge, any stalled interest from the past that may still be eligible for settlement should also be taken into account.

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