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Reorganization Clauses in Tax Treaties



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Why this book?

Reorganization Clauses in Tax Treaties analyses the tax consequences of corporate reorganizations in the context of tax treaty models and the solutions adopted in the global tax treaties network. The book also proposes solutions to be implemented in the model tax treaties in order to deal with cross-border reorganizations.

Taxation of mergers and corporate reorganizations is often regarded as one of the most complex aspects of developed tax systems. Contrary to the general realization principle, transfers of assets and liabilities in the course of corporate reorganizations are not taxed when they occur. Instead, recognition of the capital gains arising from such transfers is deferred through different mechanisms under preferential tax regimes with the objective of granting corporate reorganizations a tax neutral treatment.

However, this tax neutrality might be jeopardized when the effects of corporate reorganizations cross borders. So long as tax treaties do not cater for any special provisions dealing with the effects of corporate reorganizations, cross-border reorganizations will be hampered with the risks of overtaxation, while at the same time global tax neutrality will be compromised due to the inconsistent tax treatment of these transactions from a cross-border perspective.

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Sample chapter

The object of this book is to analyse the direct tax rules that affect corporate reorganizations in a cross-border context from a tax treaty law perspective. The analysis focuses on the impact of tax treaties on corporate reorganizations as well as on the existing conventional clauses addressing issues derived from these transactions. This analysis concludes with a proposal for the inclusion of specific clauses in tax treaties that may alleviate the negative tax consequences these transactions may face in a cross-border context. The book focuses only on the tax treaties' aspects of corporate reorganizations, leaving apart the analysis of European tax law and particularly the EU Merger Directive.

The topic of the cross-border taxation of corporate reorganizations is especially relevant in the context of the integration of national markets arising from the globalization process. The need to adapt the structure of groups of companies and individual companies to the economic environment and competition conditions requires tax rules to be neutral from the perspective of competition and not to create external distortions which affect the decisions of economic agents thereby reducing efficiency in the allocation of resources derived from the rational choice paradigm. However, this objective is not automatically extended to international and cross-border situations where the balance between tax neutrality and the safeguard of the tax claims of each state might clash, leading to inefficiencies in the allocation of resources by means of mergers and reorganizations in the cross-border context.

At the level of the European Union, the relevance of this issue motivated the adoption of a Council Directive that addresses the main tax consequences of these transactions. However, these normative solutions have not been extended to the international tax regime, leaving mergers and reorganizations without a favourable tax environment when they cross borders. Nevertheless, some proposals and studies have been carried out by international organizations in this field, although none of them has proven to be successful and in the last year some attention to this issue has been paid by the OECD and the UN in their commentaries to their model tax treaties. Yet the lack of a common tax treatment for mergers and acquisitions at the international level creates distortions and disparities which hinder foreign investment and cross-border competition that demand the adoption of solutions for the undesirable tax consequences of these transactions in the international scenario.

The book is divided into four separate chapters, a final chapter on the main conclusions of this research and an appendix and bibliography. Each chapter covers an individual aspect of the object of this research study, the structure of these chapters being as follows:

The first chapter addresses the underlying economic motivation for enterprises when undertaking a reorganization process. In this respect, the main concern is the need to adapt their legal and financial structure to the market and economic environment. However, this motivation blurs when examining each category of reorganization transactions. In this context, when examining mergers and other combinations of businesses processes, the main motivation of the parties to the transaction becomes the aim of consolidating companies and integrating business activities under a common control. This aim, *prima facie* compliant with the aim of adapting business structures to competition, is, however, often postponed in favour of other concerns such as managerial empire-building or tax motivations that become externalities with respect to market efficiency.

The second chapter provides an overview of the tax consequences of legal mergers. Spanish legislation is used as an example of a tax system under which different regimes coexist. In this regard, the general tax rules applicable to mergers require the taxation of the hidden reserves disclosed when the transaction is realized. Together with this regime, a preferential tax regime based on the application of a rollover relief exists. The rules of this regime are examined in detail, together with examples from other legislation where the relief, although aimed at excluding the same tax consequence, is based on pure deferment mechanisms. The main concern of these regimes is to prevent the immediate taxation of capital gains from influencing business decisions and thereby affect the competition. However, this objective is often distorted as these regimes include other tax elements which lead to the existence of a preference for reorganizations under forms which, *prima facie*, might be regarded as inefficient when compared to other options.

The third chapter analyses the tax consequences of mergers under the OECD Model. For these purposes, transactions are divided into cross-border structures and foreign-to-foreign structures. The analysis of the tax consequences of these transactions distinguishes between the shareholder and corporate level consequences. In this regard, the first problem for reorganizations in this context comes from the difficulties in characterizing the income derived by the parties to the transaction, specifically at shareholder level. These issues can lead to disparities in the characterization of income by each contracting state. In addition to these issues, timing mismatches

can occur when the non-recognition rules are not applied simultaneously by both states. In both cases, double taxation might occur. However, most of the situations where double taxation arises can be solved through a purposive interpretation of the rules provided in the OECD Model and recourse to its Commentaries. On the other hand, from a neutrality perspective, inefficiencies will persist as the rules provided in tax treaties will not address the problems derived from immediate taxation, leading to the eventual distortion of business decisions. Finally, the issue of the assimilation of foreign transactions for the purposes of the application of the domestic preferential tax regimes is analysed in the light of the guidance issued by the tax authorities of certain states.

The fourth chapter is devoted to the analysis of the reorganization clauses that can be found in tax treaties. Although the number of clauses in the current tax treaty network is rather reduced, their relevance for the analysis is clear. First, an analysis of common aspects that can be found in these clauses is undertaken, especially regarding the interpretative issues that can arise in the application of the clause. This analysis leads to a categorization of reorganization clauses according to their object. This classification is used to analyse the context where these clauses have been concluded, focusing on the tax treaty policy of some countries through the comparison of the treaties which include clauses of this kind and other contemporary treaties and whether the contracting states are developed or developing countries. Finally, the most relevant clauses are analysed in detail from a legal perspective. In this respect, a special focus is placed on the clause included in article XIII(8) of the Canada-United States Income and Capital Tax Treaty (1980) and its application by the contracting states. Under this clause, the competent authority is entitled to reach an agreement with the non-resident taxpayer in order to defer taxation derived from the state of source. This clause is proposed as a practicable solution for the issues derived from reorganizations in a cross-border context due to its flexibility and case-by-case approach that overcomes the potential difficulties derived from the discretion entitled to the tax authorities when applying this clause.

Finally, some reflections on the possibilities for including reorganization clauses in the model treaties and some proposals are issued in the fifth chapter along with some conclusions on this issue. The appendix includes a list of reorganization clauses in tax treaties that have been referred to in this book. Although the text of all the clauses is not included here, most of them can be consulted in the tax treaties database of the International Bureau of Fiscal Documentation (IBFD) and in other tax treaties' databases.

Respecting the methodical aspects of the research, the following aspects must be outlined. The research carried out for the purposes of this thesis has been based on the classical doctrinal analysis of the law and the interpretation of legislation according to the principle and criteria of interpretation relevant to the nature of the particular item of legislation analysed. This analysis is completed with references to judicial and administrative rulings and official guidance issued where available. Finally, prior scholarly works have been used as reference materials.

In addition to the pure legal research method, some references to business literature have been used in the framework of the first chapter of this thesis in order to address the motivation of the participants in mergers and reorganizations. Finally, basic statistical analysis is used in the framework of the contextualization of reorganization clauses attempted in the fourth chapter of this work.

The context in which the book is situated and the main results and contributions to further discussions can be summarized as follows. Reorganizations have been widely analysed in business literature, especially with respect to the motivations of the participants to undertake these transactions. In the area of tax law, there are many studies on the tax consequences of these transactions and the positive analysis of the legislation, especially in the context of preferential tax regimes. The justifications for the existence of these regimes, however, have not been fully explored in the European context, while among American scholars they have been subject to a heated debate since the second half of the 20th century.

In the field of international taxation, the consequences of reorganizations have not been subject to such extensive research and analysis, mainly due to the lack of an adequate company law environment and the fact that these transactions are relatively recent in the cross-border context. Respecting the existence of specific clauses in tax treaties providing relief for corporate reorganizations, the same lack of extensive analysis is to be found, although the quality of the few previous researches in this area provides sufficient grounds for the development of a line of reasoning that has been adopted by some international organizations. In the context of Spain, the number of studies focused on the cross-border tax consequences of mergers and reorganizations and the specific treaty clauses found in the Spanish tax treaty network is also scarce.

This research therefore constitutes the first comprehensive analysis of the tax implications of mergers and reorganizations in the context of tax treaties.

In this regard, the findings of the research might prove helpful when drafting tax treaties where a provision respecting the taxation of corporate reorganizations is considered to be necessary to strengthen the flows of trade and investment between the contracting states and as a source of information and critical analysis on the existing reorganization clauses in the tax treaties network.

Chapter 1

The (Non-)Definition of Corporate Reorganizations Grounds for Combination of Businesses

1.1. Introduction: Concept and classifications of corporate reorganizations

More than three decades ago, Gammie and Ball commenced their monographic book on the taxation of corporate reorganizations, acknowledging the difficulties and impossibility of elaborating a concept of corporate reorganizations. According to these authors, the variety of legal forms and transactions through which an entity could attempt a process of reorganization was virtually infinite. In this context, the authors concluded that there were as many classes of reorganizations as companies recorded in the commercial register due to the need to find tailored solutions for the need to reorganize each company.¹

After 30 years, there are still difficulties in developing a concept for the phenomenon of corporate reorganizations. The diversity of transactions through which a company can reorganize its business prevents the concept of corporate reorganizations from being defined in any other than a vague manner. For the purposes of the present research, although the focus will be on a few transactions that can be included within the category of reorganizations, it is interesting to first address this concept in order to assess the tax legislators' rationale for giving special tax treatment to certain of the transactions apt to serve as a means for the reorganization of companies.

In view of the difficulties in defining corporate reorganizations, some authors have used a vague definition of the term based on the effects of the transactions for the companies that undertake these operations. In this regard, Vanistendael generally includes within this concept "transactions involving significant changes in the legal or economic structure of one or more business enterprises."² Clearly, this definition encompasses all the different transaction which can serve "to organize [the structure of an

1. Gammie & Ball (1982), p. 1.
2. Vanistendael (1998b), p. 897.

enterprise] again in order to improve it.”³ Consequently, from an economic perspective, the concept of corporate reorganizations does not have clear borders,⁴ due to the variety of possible modifications of the structure of a company or enterprise, it being difficult to define this concept from a legal perspective.⁵ Therefore, most jurisdictions do not include a concept of corporate reorganizations in their company or tax laws,⁶ and when doing so, the transactions included only represent a portion of the possible operations that can be used to reorganize the structure of a company.⁷

3. *Cambridge Advanced Learner’s Dictionary* 2008 ed. (Cambridge, Cambridge University Press 2008); definition of the verb “to reorganize” (“to organize something again in order to improve it”).

4. For example, Navarro Egea (1997), p. 21, defines business restructuring as “a transformation of the elements that integrate an Enterprise within a process of economic growth to which is directed towards so as to respond to the most varied exigencies derived from the economic, social and politic conditions of each economic or historical space.”

5. In this sense, Ansón Peironcelly and Garrido de Palma (2010), p. 26, argue that many transactions can modify the structure of a company with varying degrees of intensity, e.g. the sale of the participations of some shareholders or the increase in the capital share of the company; but, in the opinion of these authors, from a legal perspective, only when the agreement on the incorporation of the company itself is substantially modified as a result of the transaction.

6. For example, under Spanish domestic company law, there is no concept of corporate reorganizations. However, there is a similar concept called structural modifications of companies. These transactions are regulated by Law 3/2009, including transformations, mergers, divisions, contributions of economic segments to other companies, global transfers of assets and liabilities (*cesión global de activo y pasivo*) and the change of corporate domicile to another jurisdiction. According to the preamble of the relevant legislation, corporate structural modifications are those changes in the company which go beyond the simple change of the by-laws and affect the personal or capital structure of the company. However, this list does not have an exact parallel in tax legislation (*see* article 83 et seq. of the Spanish Corporate Income Tax Act, CITA); some of the transactions envisaged there not being included in the scope of the preferential tax regime for mergers and other reorganizations and vice versa.

7. Although some jurisdictions do have a legal concept of corporate reorganizations for tax purposes, they hardly include all the possible transactions that can serve to reorganize the structure of a company within this category. The best example of tax legislation including a broad definition of reorganizations is the US legislation, where, under §368(a) of the Internal Revenue Code (IRC), certain transactions are regarded as reorganizations for tax purposes (legal mergers, qualified shares and assets acquisitions, including de facto mergers, divisive transactions, recapitalizations, changes of identity, legal form or corporate seat and bankruptcy reorganizations). Additionally, other transactions, such as divisions (§355) and contributions of assets to companies (§351), enjoy a close tax treatment, which facilitates the reorganization of companies and, provided they meet some specific requisites, can fall within the definition of transactions included in the general definition of reorganizations (*see generally* Block (2004), p. 445 et seq.). On the other hand, some jurisdictions, such as Argentina, have a more restrictive approach to the definition of corporate reorganizations for tax purposes. In this regard, the Argentinian Capital Gains Tax Act (*Ley del Impuesto a las Ganancias*) includes legal mergers and divisions and transfers and sales of assets between affiliated companies within the scope of the definition of corporate reorganizations.

Therefore, in order to determine the conditions for considering a transaction to be potentially included within the reorganizations “category”, the first step is to determine the objective of the companies entering into these transactions. Generally, the paramount objective of a company when undertaking a reorganization is to achieve a better structure from a legal or economic perspective so as to improve the organization of the enterprise in order to enhance its competitive position in the relevant market, thus enabling it to take advantage of market opportunities and gain competitive advantages through synergies, reallocation of risks or an extension of the company’s offer or market.⁸ This aim of improving the legal or economic structure of a company can take different forms according to the specific needs of each organization. Additionally, there are other feasible explanations for these transactions that might blur or even exclude this paramount aim of reorganizing a company. Nevertheless, for the purposes of this section, it will be assumed that the main reason for undertaking a reorganization is to improve the structure of the company.

Even though there are virtually unlimited transactions that might serve the general objective of improving the structure of a company, since the transactions must be tailor-made to the needs of a particular company,⁹ there are some categories within which most reorganization transactions can be included in a broad sense. In this respect, a useful classification of the transactions that can generally be used for the purpose of reorganization will first make a distinction based on the number of companies participating in the transaction. In this regard, a distinction is made between internal and external reorganizations.

Internal reorganizations or internal restructuring are those transactions where only the company which reorganizes its structure participates, i.e. they take place within the same company.¹⁰ The aim of these transactions is to achieve a more efficient financial, legal or functional structure so as to reduce costs and risks, improve the financial capacity or gain competitive advantages. The most common reorganizations in this case are those which affect either the legal structure of the company or its financial structure. Examples of transactions that modify the legal structure of the company are reincorporations or changes of the real seat of the company as well as transformations. In these cases, the statutes of the company are amended in order to be adapted to a new legal configuration either resulting from the

8. McCann & R. Gilkey (1990), p. xiii.

9. Gammie & Ball (1982), pp. 1-2.

10. See Block (2004), p. 346.

transformation of the legal form of the company, e.g. from a limited liability company to a partnership or to another corporate structure, provided they do not require the transforming company to liquidate; or in the event that as a result of the transaction the company is subject to a new jurisdiction, e.g. where as a result of the change of real seat, the company changes its law of incorporation.¹¹ Other internal reorganizations affect the financial structure of the company, increasing the sources of external or internal funding or modifying the ratio between these sources. Some examples of these transactions range from recapitalizations,¹² debt restructuring or workouts,¹³ to changes in the share capital of the company.¹⁴ Finally, in a broad sense, other forms of restructuring that do not imply any modification at a financial or legal level but do affect the way the enterprise is structured can take place in order to reallocate functions and risks among the segments of the company.¹⁵

On the other hand, external reorganizations affect more than one single company. In this context, a distinction can be drawn between transactions that combine the business enterprise of two or more companies and transactions aimed at dividing the enterprise structure of a company into two or more companies. The general reorganization purpose of these transactions consists in allowing the participant companies to restructure their size according to competition in the relevant market and obtain competitive advantages over other competitors. Additionally, these objectives might include reaching economies of scale, eliminating duplication of costs, accessing new markets or distributing risk in a more efficient manner.

11. Vanistendael (1998b), p. 900 defines these transactions as follows: “[A] change in seat is a change in the jurisdiction of incorporation, while a change in form is a change from one type of company to another. Both consist of legal structural changes, but do not necessarily involve economic changes in the way the business of the company is conducted. The assets and liabilities and the economic activity of the company whose seat or form is changed remain unchanged. When the seat of a company is moved from one country to another, or when the form of the company is changed, the company law may provide that the company is liquidated and that a new company is established. Generally speaking, however, when the seat is moved within the same country or when the form is changed, most company laws stipulate that the legal identity of the company remains unchanged.”

12. Recapitalizations are “changes in the way a company is financed, that is, structural changes in its share capital or outstanding debt” (Vanistendael, id.).

13. Debt restructuring and debt workouts can be defined as “[d]ebt restructuring is the generic term describing the process irrespective of the cause of the restructuring or the way in which it is achieved. The term ‘debt work-out’ suggests debt restructuring with a certain level of cooperation by (some) creditors, although it may also occur in a settlement reached during a procedure led by a court-appointed trustee or administrator” (Lambooi (2006), p. 28).

14. See some examples of qualifying recapitalizations referred to in Bittker & Eustice (2000), ¶ 12.27.

15. See Bueno Campos (2001), p. 379; Hunt (2009), §18.03.

As a result of reorganizations that involve the combination of businesses or acquisitive reorganizations, a company acquires either the control or the assets of another company in order to integrate their activities. In order to analyse these transactions a distinction is first made between transactions following which the acquired company ceases to exist after the transaction or completion of the reorganization plan and transactions where the target company maintains its separate legal existence. Mergers, in a broad sense, i.e. not only legal mergers but also other de facto mergers, are included within the first category, to the extent that they involve the integration of two companies, and that at least one of them ceases to exist after the completion of the reorganization.

Acquisitive reorganizations that do not involve the cessation of existence of the target company can be distinguished on the basis of whether or not they involve compensation being given to the shareholders of the acquired company and the type of compensation given. In this respect, combinatory reorganizations that do not necessarily involve any compensation for the shareholders of the target company encompass, inter alia, dual-listed companies schemes and other contractual mergers¹⁶ or enterprise alliances.¹⁷ These transactions do not in principle involve any change to the economic or legal structure of the participating companies, their effects being shown at the level of corporate governance.¹⁸ On the other hand, the acquisition of the control of a company through the purchase of the majority of its share

16. See Ault & Arnold (2004), p. 382; Terra & Wattel (2008), p. 522. Dual-listed company structures are defined by Bedi and Tennant as “effectively mergers between two companies in which the companies agree to combine their operations and cash flows, but retain separate shareholder registries and identities One form of DLC involves the two companies transferring their assets to one or more jointly owned subsidiary holding companies. The holding company then passes dividends back to the main companies, which distribute them to shareholders according to a predetermined ratio. Alternatively, instead of the transfer of assets, there may be contractual arrangements to share the cash flows from each other’s assets.... Under this arrangement, the individual companies retain their separate assets but align their operations by having either a single board of directors or identical boards elected through a joint voting mechanism. The companies pay equal dividends to their shareholders, and shareholders have equivalent votes in the decisions regarding the two companies, in line with the relative ‘weights’ of the two companies established at the time of the creation of the DLC” (Bedi & Tennant (2002), pp. 7-8).

17. See, inter alia, Weston, Mitchell & Mulherin (2004), p. 365 et seq.

18. Paz-Ares (1999), pp. 227-228.

capital can be structured by issuing shares of the acquirer to the shareholders of the target company through an exchange of shares or share merger¹⁹ or by exchanging cash or other assets for the shares of the target.²⁰

In divisive reorganizations, on the other hand, the activities or divisions of a company are split among one or more companies.²¹ As in the case of acquisitive reorganizations, the first distinction is based on whether or not the transferring company disappears as a result of the transaction. The first set of cases includes demergers or total divisions of companies that result in the transferring company disappearing as a result of the transaction or reorganization plan, the corporate segments or divisions of the company being transferred to two or more separate entities.²² On the other hand, the second set of cases includes different transactions depending on the person who receives compensation for the transfer of the corporate segment of the transferring company and its qualification. If the compensation consists in shares in the capital of the beneficiary or beneficiaries companies being

19. Exchanges of shares entitling the acquiring company to control more than 50% (or a higher threshold) of the capital of the acquired company are often regarded as share or stock mergers, which are put at the same level for tax purposes as legal mergers due to the change in the capital structure and control of the acquired company being substantially comparable as an acquisition of the underlying assets of the company. *See*, for example, De Jong & van Woerkom (2012), § 4.5.1.1 (last retrieved 16 Aug. 2013).

20. *See* Vanistendael (1998b), p. 899.

21. US tax legislation includes a specific type of divisive reorganizations under §368(a)(1)(D) where “[t]hree types of divisive reorganizations can be identified. In a spin-off, the shares of a subsidiary are distributed to the shareholders of the parent company. In a split-off, the shares of a subsidiary are distributed in exchange for the surrender of shares of the parent company. In a split-up, the parent company distributes its shares in two or more subsidiaries in complete liquidation” (Vanistendael (1998b), pp. 898-899). These transactions do not necessarily correspond to the concept of division or demerger under European company law referred to *infra* n. 22.

22. The EU Sixth Council Directive of 17 December 1982 (82/891/EEC), concerning the division of public limited liability companies, distinguishes between full divisions where the acquiring companies pre-exist and where the acquiring companies are created upon the transaction. The first type of transactions, “division by acquisition”, is defined in article 2 of the Directive as “the operation whereby, after being wound up without going into liquidation, a company transfers to more than one company all its assets and liabilities in exchange for the allocation to the shareholders of the company being divided of shares in the companies receiving contributions as a result of the division (hereinafter referred to as ‘recipient companies’) and possibly a cash payment not exceeding 10 % of the nominal value of the shares allocated or, where they have no nominal value, of their accounting par value.” On the other hand, article 21 defines the second set of transactions, “division by the formation of new companies”, as “the operation whereby, after being wound up without going into liquidation, a company transfers to more than one newly-formed company all its assets and liabilities in exchange for the allocation to the shareholders of the company being divided of shares in the recipient companies, and possibly a cash payment not exceeding 10 % of the nominal value of the shares allocated or, where they have no nominal value, of their accounting par value.”

received by the shareholders of the transferring company, the transaction would qualify as a partial division of the transferring company.²³ On the contrary, when the compensation in shares of the beneficiary company is received by the transferring company without being transferred to its shareholders, the transaction would imply the contribution of assets or a business unit to another company in exchange for its shares.²⁴ Finally, the sale of a business unit of the transferring company would also affect the structure of the company.²⁵

The distinctions, shown in Table 1, basically differentiate possible types of corporate reorganizations that can occur in a broad sense; nevertheless, other distinctions can be drawn based on whether the reorganization is, for example, between affiliated companies or independent parties.²⁶ However, the classification in Table 1 is helpful as it divides the different reorganizations according to the main features of each class, so as to address the parties' main motivation for undertaking the transaction. The following section discusses this classification.

1.2. Combination of businesses through reorganizations

The phenomenon of combining businesses involves the integration of enterprises through either the direct acquisition of the underlying enterprise by a company or the acquisition of its control through the purchase of most of its share capital or through agreements among the different shareholders.

23. For example, the EU Merger Directive defines partial divisions as “an operation whereby a company transfers, without being dissolved, one or more branches of activity, to one or more existing or new companies, leaving at least one branch of activity in the transferring company, in exchange for the pro-rata issue to its shareholders of securities representing the capital of the companies receiving the assets and liabilities, and, if applicable, a cash payment not exceeding 10 % of the nominal value or, in the absence of a nominal value, of the accounting par value of those securities” (EU Merger Directive (2009): Council Directive 2009/133/EC of 19 October 2009 on the Common System of Taxation Applicable to Mergers, Divisions, Partial Divisions, Transfers of Assets and Exchanges of Shares Concerning Companies of Different Member States and to the Transfer of the Registered Office of an SE or SCE between Member States (Codified Version), art. 2(c), OJ L310 (2009), EU Law IBFD). Spanish tax legislation, for example, also includes partial divisions that only involve the transfer of a holding of shares (*see* article 83(2)(1)(c) of the CITA).

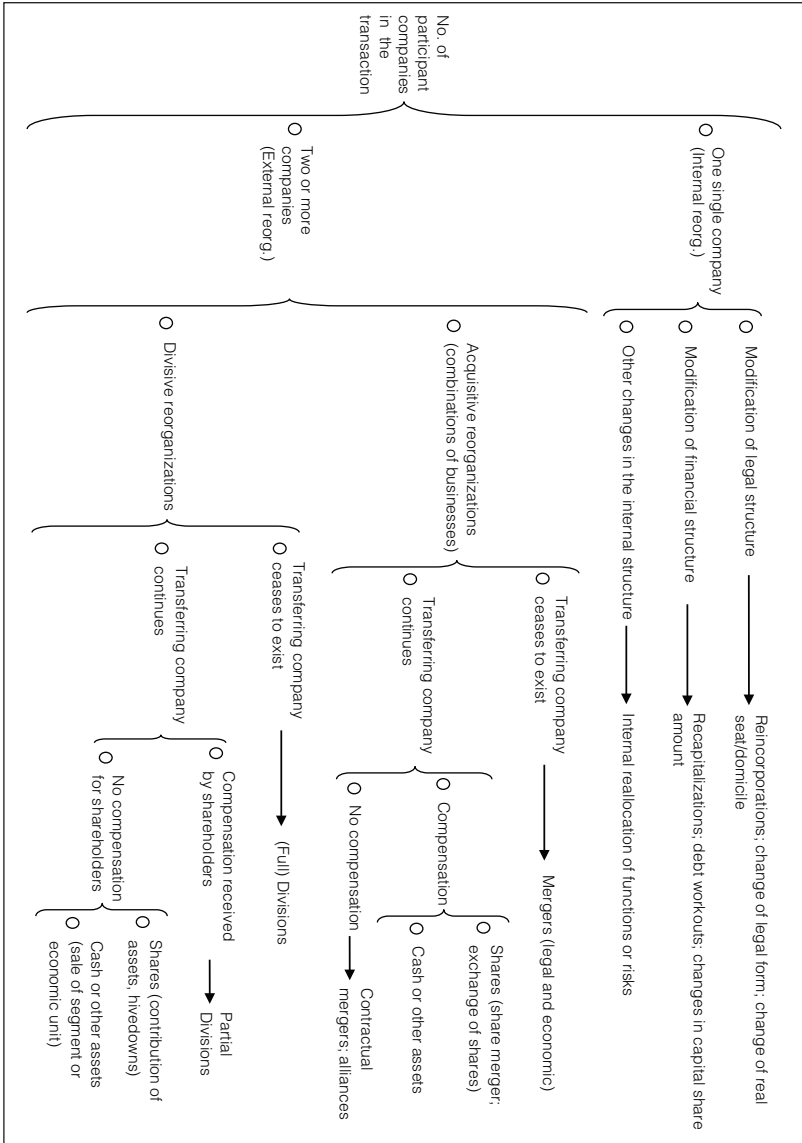
24. This is sometimes referred to as an asset merger (Calderón Carrero & Martín Jiménez (2009b), p. 1.094).

25. *See* Vanistendael (1998b), p. 899.

26. These are often referred to as “internal reorganizations” given that the transaction takes place within a single economic group of companies.

Chapter 1 - The (Non-)Definition of Corporate Reorganizations Grounds for Combination of Businesses

Table 1. Classification of corporate reorganizations



The general motivations for attempting the combination of the businesses of two or more companies are normally the growth in the size of the acquiring companies, entering new markets or gaining economies of scale. However, these motivations depend to a great extent on the relative positions of the companies involved in the transaction. In this respect, it is common from an economic perspective to distinguish between horizontal and vertical combinations of businesses and conglomerates.²⁷

Horizontal combinations of businesses involve the combination of two or more companies or enterprises that operate in the same segment of the relevant market, i.e. competitor companies.²⁸ In this respect, competition is analysed in relevant market terms.²⁹ These types of combinations of businesses are normally examined for the purposes of antitrust legislation provided they result in the combination of two or more competitors reducing the number of competitors in the relevant market and the acquisition of a greater market share by the acquiring company.

Vertical combinations of businesses involve the integration of companies that are part of the production or distribution chain for a relevant product or service.³⁰ An example is the acquisition by the manufacturer company of one of its suppliers. The element differentiating these transactions is often seen as the companies having a current or potential buyer-seller relationship.³¹ As a consequence of these transactions, different stages of the production or distribution chain will be controlled by the same operator. Additionally, a further differentiation is made between forward and backward integrations of businesses depending on whether the acquirer moves forward or backward in the production chain as a result of the transaction, e.g. the acquisition of a supplier would imply a backward integration, whereas the acquisition of the client would imply a forward integration.³²

Finally, conglomerates are combinations of businesses that do not fall within the former two categories.³³ Therefore, these transactions imply the combination of two or more businesses that are not potential competitors and which do not have a potential buyer-seller relationship. Three different

27. Weston, Mitchell & Mulherin (2004), pp. 6-10; Gaughan (2007), p. 13.

28. Gaughan, *id.*

29. *Id.* On the other hand, Megginson, Smart & Lucey (2008), p. 572, do not distinguish the relevant market for the purposes of qualifying a merger as a horizontal merger.

30. Weston, Mitchell & Mulherin (2004), p. 7.

31. Megginson, Smart & Lucey (2008), p. 572.

32. *Id.*

33. Gaughan (2007), p. 13.

types of conglomerates can be distinguished within this category. First, product extension combinations involve the integration of companies that sell competing rather than related products.³⁴ Secondly, geographic extension combinations involve the integration of companies that produce competing products but operate in different markets.³⁵ Finally, pure conglomerates imply the integration of companies that have no relationship.³⁶ Clearly, the underlying motivations for each type of conglomerate differ, although to a certain extent they might be explained by the diversification or limitation of risks.

As previously explained, a combination of businesses can involve the use of different structures and transactions. In this respect, there are three basic methods for achieving integration: mergers; acquisitions and contractual arrangements.

One possible way to combine businesses is to acquire the shares of the target company, thus obtaining the control over the company. In these transactions, the acquirer purchases the number of shares representing the capital of the target company that would allow it to control the activities of the later company. In this scenario, the shareholders of the target company sell or exchange their shares to the acquirer company. In order to finance the acquisition the acquirer may pay the shareholders of the target company cash or some assets in exchange for their participations in the target company or issue shares in its capital, thus integrating the shareholders of the target company in its capital.³⁷ In principle, the transaction does not differ from a sale from the perspective of the shareholder who sells his shares in the target company;³⁸ this qualification also being applicable, *prima facie*, for tax purposes.³⁹ However, in some cases, when the transaction is financed through the issuing of shares by the acquiring company to the shareholders of the target company, a preferential tax treatment is often provided primarily on the purported grounds that the transaction could not otherwise be realized due to the lack of liquidity of the shareholders.⁴⁰

Another way to undertake a combination of businesses entails the perfection of contractual arrangements that create a scheme of *de facto* integration of

34. Weston, Mitchell & Mulherin (2004), p. 7.

35. *Id.*, pp. 7-8.

36. *Id.*, p. 8.

37. *See, inter alia, id.*, pp. 96-97.

38. Vicent Chuliá (1971), p. 368 et seq.; Vinther (2002), p. 123 et seq.

39. Navarro Egea (1997), p. 103.

40. Auerbach & Reishus (1987), pp. 6-85.

the activities of the companies involved, despite not implying a legal integration of the companies involved; or the creation of new companies through which the activities of the participating companies are channelled. The first category comprises domination contracts,⁴¹ “parasocial” agreements or agreements between significant shareholders respecting the governance of the company,⁴² and other contractual schemes such as “dual-listed companies” arrangements.⁴³ These transactions do not have direct implications for tax purposes, provided no income or wealth is disclosed as a result of their performance.

On the other hand, other schemes for integrating the activities of companies, at least partially, involve the creation of another company through which part or the totality of the activities of the integrating companies are channelled. This is the case of joint ventures or other collaboration schemes.⁴⁴ In principle, these transactions do not have direct tax effects provided there is no transfer of assets between the participant companies but rather the allocation of functions to the newly created company.

Finally, the companies’ activities can be integrated through the direct merger of the involved companies. Such transactions will be the primary focus of this research. Mergers entail at least one of the companies transferring all its assets and liabilities to another company followed by which the former company ceases to legally exist independently. At shareholder level, the transaction will imply that the shareholders of the transferring company will be integrated in the capital of the acquirer. Therefore, the transaction involves an integration of the assets and liabilities of two or more companies as well as the integration of their capital through the inclusion of the shareholders of the transferring company in the capital of the beneficiary company.⁴⁵

These transactions can take place in different modalities or schemes depending on the situation of the companies involved and the integration of the shareholders after the transaction. From a tax perspective, these transactions have some relevance as they involve transfers and exchanges at both corporate and shareholder levels. In this respect, although the transfers that take place in the course of mergers can be assimilated to the sale of the assets of the transferring company and the sale of the shares of the shareholders of that company, it is common for tax legislation to provide some relief

41. Paz-Ares (1999), p. 233.

42. Id., p. 234.

43. Bedi & Tennant (2002), pp. 7-8.

44. See, inter alia, Gaughan (2007), p. 519 et seq.; Paz-Ares (1999), pp. 228-229.

45. Vanistendael (1998b), p. 898.

for these transactions based on the lack of liquidity arising in the course of these transactions and the difficulties the parties might have in performing the transaction if taxation were to be levied upon the parties to the merger.⁴⁶

1.3. The different classes of mergers

In strict legal terms, mergers are private law procedures that allow the integration of two or more companies within one single company without involving the liquidation of the transferring company.⁴⁷ This legal concept of merger is widespread, although not exclusively, among Continental jurisdictions where the transaction is carried out through the universal succession of the beneficiary company in the positions of the transferring company, i.e. all the assets and liabilities of the transferring company are transferred automatically (*ope legis*) to the beneficiary company.⁴⁸

On the other hand, most common law jurisdictions do not have a comparable legal concept,⁴⁹ even though they normally allow for the integration of companies with the same substantial effects as Continental law mergers through the liquidation of the transferring company or through the dissolution without liquidation under judicial sanction.⁵⁰ Nevertheless, in both cases, the effects of the transaction do not differ substantially as they will imply the integration of companies and their shareholders in a single entity

46. See generally ALI (1982), pp. 157-158.

47. See Vanistendael (1998b), p. 898.

48. See, inter alia, Vicent Chuliá (1971), pp. 280-293.

49. However, under certain US states' legislation, mergers can be perfectly assimilated to Continental law mergers, even considering the transfer of assets and liabilities taking place with comparable effects to those derived from the principle of universal succession. See Couret (2009), pp. 375-376. In this respect, it is worth noting that the universal succession principle is implied in § 259 of the Delaware General Corporation Law (Title 8, Chapter 1 of the Delaware Code) or § 906 of the New York Business Corporation Code.

50. See, for example, the case of UK reconstructions and other schemes of arrangements. It should be noted that these terms are not terms of art. Reconstructions and other liquidations of companies can be assimilated to Continental law mergers when the transaction results in the transfer of the assets of the liquidating company in exchange for shares in its capital to be offered to the shareholders of the transferring company and being the liabilities transferred with the consent of the creditors. On the other hand, under a scheme of arrangement sanctioned by the courts, the same result can be obtained, but the transfer of assets and liabilities occur automatically due to judicial intervention. Cf. Keenan (2005), p. 490 et seq.; Tomsett (2008), § 1.1.2-1.1.3 (last retrieved 9 Nov. 2010); Francis Lefebvre (2005), § 5,839 et seq.

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