Taxation of cross-border mergers and acquisitions

Philippines
Introduction

In recent years, corporate acquisitions, business reorganizations, combinations and mergers have become more common in the Philippines. Corporate acquisitions can be effected through a variety of methods and techniques, and the structure of a deal can have material tax consequences. Although reorganizations are generally taxable transactions, tax-efficient strategies and structures are available to the acquiring entity.

Recent developments

Republic Act 10667

In 2015, one major law was enacted affecting mergers and acquisitions (M&A) in the Philippines. Republic Act No. 10667, also known as the ‘Philippine Competition Act’, was signed into law on 21 July 2015. It provides for the creation of an independent, quasi-judicial body called the Philippine Competition Commission.

The law grants the commission the power to review mergers and acquisitions based on factors the commission deems relevant. M&A agreements that substantially prevent, restrict or lessen competition in the relevant market or in the market for goods or services, as the commission may determine, are prohibited, subject to certain exemptions.

Parties to a merger or acquisition agreement with a transaction value exceeding 1 billion Philippine pesos (PHP) are barred from entering their agreement until 30 days after providing notification to the commission in the form and containing the information specified in the commission's regulations. An agreement entered in violation of this notification requirement would be considered void and subject the parties to an administrative fine of 1–5 percent of the transaction’s value.

The law also provides that the commission shall promulgate other criteria, such as increased market share in the relevant market in excess of minimum thresholds, which may be applied specifically to a sector or across some or all sectors in determining whether parties to a merger or acquisition should notify the commission.

If the commission determines that such agreement is prohibited and does not qualify for exemption, the commission may:

— prohibit the agreement’s implementation
— prohibit the agreement’s implementation until changes specified by the commission are made
— prohibit the agreement’s implementation unless and until the relevant party or parties enter into legally enforceable agreements specified by the commission.

The Commission published Memorandum Circulars (MC) Nos. 16-001 and 16-002 on 22 February 2016 and they will take effect on 8 March 2016. MC 16-001 provides for transitional rules for M&As executed and implemented after the effective date of the Philippine Competition Law and before the effective date of its Implementing Rules and Regulations (IRR). Similarly, MC 16-002 provides transitional rules for M&As of companies listed with the Philippine Stock Exchange.

Application for tax treaty relief

On 25 August 2010, the Bureau of Internal Revenue (BIR) issued Revenue Memorandum Order 072-10, which mandates the filing of a tax treaty relief application (TTRA) for entitlement to preferred tax treaty rates or exemptions. The TTRA must be filed before the occurrence of the first taxable event (i.e. the activity that triggers the imposition of the tax).

The BIR relaxed the TTRA filing deadline after a Philippine Supreme Court ruling in August 2013. In that case, the BIR denied a TTRA because the taxpayer failed to file their TTRAs before the occurrence of the first taxable event. The court held that the obligation to comply with a tax treaty takes precedence over a BIR revenue memorandum.

Asset purchase or share purchase

An acquisition in the Philippines may be achieved through a purchase of a target’s shares, assets or entire business (assets and liabilities). Share acquisitions have become more common, but acquisitions of assets only still occur. A brief discussion of each acquisition method follows.
**Purchase of assets**

Income from an asset acquisition is taxed in the Philippines where the transfer of title or ownership takes place in the Philippines. This is an important consideration for planning and structuring an asset acquisition. Generally, the value of an asset is its selling price at the time of acquisition. For purposes of determining gain or loss, the gain is the amount realized from the sale over the asset's historical or acquisition cost or, for a depreciable asset, its net book value.

**Purchase price**

To help avoid questions from the tax authorities on the valuation of an asset, the selling price should be at least equivalent to the book value or fair market value (FMV) of the asset, whichever is higher. In a purchase of assets in a business, it is advisable that each asset be allocated a specific purchase price in the purchase agreement, or the tax authorities might arbitrarily make a specific allocation for the purchase price of those assets. In addition, in an acquisition of assets, a sale comes within the purview of the Bulk Sales Law if it is a sale of all or substantially all of the trade or business or of the fixtures and equipment used in the business. The seller must comply with certain regulatory requirements; if not, the sale is considered fraudulent and void.

**Goodwill**

Goodwill is not subject to depreciation. The tax authorities have consistently held that no amount of goodwill paid may be deducted or amortized for tax purposes unless the same business or the assets related to the goodwill are sold. Thus, for tax purposes, since goodwill is not deductible or recoverable over time in the form of depreciation or amortization allowances, the taxpayer can only recover goodwill on a disposal of the asset, or a part of it, to which the goodwill attaches. In this case, the gain or loss is determined by comparing the sale price with the cost or other basis of the assets, including goodwill.

In the sale of a business or asset, payment for goodwill is normally included as part of the purchase price without identifying the portion of the purchase price allocated to it. Therefore, goodwill could form part of the purchase price for purposes of determining gain or loss from the subsequent sale of the business or assets, or for depreciation of depreciable assets.

Intangibles, such as patents, copyrights and franchises used in a trade or business for a limited duration, may be subject to a depreciation allowance. Intangibles used in a business or trade for an unlimited duration are not subject to depreciation. However, an intangible asset acquired through capital outlay that is known, from experience, to be of value to the business for only a limited period may be depreciated over that period. On the sale of a business, a non-competition payment is a capital expenditure that may be amortized over the period mentioned in the agreement, provided the non-competition is for a definite and limited term. Any loss incurred on the sale may be claimed as a deduction from gross income, except for capital losses, which can only be used to offset capital gains.

**Depreciation**

Depreciation allowances for assets used in trade and business are allowed as tax deductions. Any method, such as straight-line, declining-balance, sum-of-the-years’ digit and rate of depreciation, may be adopted as long as the method is reasonable and has due regard to the operating conditions under which it was chosen.

An asset purchase does not generally affect the depreciation. Usually, the purchaser revalues the life of the asset purchased for the purposes of claiming the tax-deductible allowance.

**Tax attributes**

An acquisition of assets may be structured tax-free (non-recognition of gain or loss) when property is transferred to a corporation in exchange for stock or units of participation, resulting in the transferor, alone or with no more than four others, gaining control (at least 51 percent of voting power) of the corporation. However, if money or other property (boot) is received along with the shares in the exchange, any gain is recognized up to the value of the boot and FMV of other property where the transferor does not distribute the boot. Gains should also be recognized if, in the exchange, a party assumes liabilities in excess of the cost of assets transferred. Losses cannot be deducted.

The provisions for tax-free exchanges merely defer the recognition of gain or loss. In any event, the original or historical cost of the properties or shares is used to determine gain or loss in subsequent transfers of these properties.

In later transfers, the cost basis of the shares received in a tax-free exchange is the same as the original acquisition cost or adjusted cost basis to the transferor of the property exchanged. Similarly, the cost basis to the transferee of the property exchanged for the shares is the same as it would be to the transferor.

The formula for determining substituted basis is provided in BIR Revenue Memorandum Ruling No. 2-2002. ‘Substituted basis’ is defined as the value of the property to the transferee after its transfer and the shares received by the transferor from the transferee. The substituted bases of the shares or property are important in determining the tax base to be used in a tax-free exchange when calculating any gain or loss on later transfers.

**Value added tax**

In asset acquisitions, a 12 percent valued added tax (VAT) is imposed on the gross selling price of the assets purchased in the ordinary course of business or of assets originally intended for use in the ordinary course of business. Mergers and tax-free exchanges are not subject to VAT, except on the exchange of real estate properties (Revenue Regulations 16-2005 implementing RA 9337).
In 2011, in Revenue Regulations (RR) No. 10-2011, the BIR held that the transfer of goods or properties used in business or held for lease in exchange for shares of stock is subject to VAT. This treatment applies whether or not there is a change in the controlling interest of the parties. This creates a conflict where an acquisition is subject to VAT but not to income tax.

Perhaps as an attempt to cushion the effects of this pronouncement, the BIR subsequently released Revenue Regulations 13-2011. As a result, VAT only applies on transfers of property in exchange for stocks where the property transferred is an ordinary asset and not a capital asset. This relief is limited as it only applies where the transferee is a real estate investment trust (REIT).

In 2014, the BIR issued a ruling stating that the transfer of assets to a corporation in exchange for the corporation's shares is not exempt from VAT as it is not specifically provided under Section 109 of the Philippine Tax Code, as amended.¹

**Transfer taxes**

An ordinary taxable acquisition of real property assets is subject to stamp duty. In tax-free exchanges, no stamp duty is due. In all cases, transfers of personal property are exempt from stamp duty.

**Purchase of shares**

The shares of a target Philippine company may be acquired through a direct purchase. Gains from the sale are considered Philippine-source income and are thus taxable in the Philippines regardless of the place of sale. Capital gains tax (CGT) is imposed on both domestic and foreign sellers. Net capital gain is the difference between the selling price and the FMV of the shares, whichever is higher, less the shares’ cost basis, plus any selling expenses. In determining the shares’ FMV, the adjusted net asset method is used whereby all assets and liabilities are adjusted to FMVs. The net of adjusted asset minus the liability values is the indicated value of the equity. The appraised value of real property at the time of sale is the higher of:

- FMV as determined by the Commissioner of Internal Revenue
- FMV as shown in the schedule of values fixed by the provincial and city assessors
- FMV as determined by an independent appraiser.

Accordingly, for CGT purposes, it is advisable that the selling price not be lower than the FMV. Capital gains are usually taxed at:

- 5 percent (for amounts up to PHP100,000) and 10 percent (for amounts over PHP100,000) for sales of unlisted shares
- one-half of 1 percent of the gross selling price or gross value in money for sales of publicly listed/traded shares.

A capital loss from a sale of shares is allowed as a tax deduction only to the extent of the gains from other sales. In other words, capital losses may only be deducted from capital gains.

Most acquisitions are made for a consideration that is readily determined and specified, so for share purchases, it is imperative that shares not be issued for a consideration less than the par or issued price.

Consideration other than cash is valued subject to the approval of the Philippine Securities and Exchange Commission (SEC).

**Tax indemnities and warranties**

When the transaction is a share acquisition, the purchaser acquires the entire business of the company, including existing and contingent liabilities. It is best practice to conduct a due diligence review of the target business. A due diligence review report generally covers:

- any significant undisclosed tax liability of the target that could significantly affect the acquiring company’s decision
- the target’s degree of compliance with tax regulations, status of tax filings and associated payment obligations
- the material tax issues arising in the target and the technical correctness of the tax treatment adopted for significant transactions.

Following the results of the due diligence review, the parties execute an agreement containing the indemnities and warranties for the protection of the purchaser. As an alternative, it is possible to spin-off the target business into a new company, thereby limiting the liabilities to those of the target.

**Tax losses**

The change in control or ownership of a corporation following the purchase of its shares has no effect on any net operating loss (NOL) of the company. The NOL that was not offset previously as a deduction from gross income of the business or enterprise for any taxable year immediately preceding the taxable year in question is carried over as a deduction from gross income for the 3 years immediately following the year of such loss. The NOL is allowed as a deduction from the gross income of the same taxpayer that sustained and accumulated the NOL, regardless of any change in ownership. Thus, a purchase of shares of the target corporation should not prevent the corporation from offsetting its NOL against its income.

**Crystallization of tax charges**

As a share acquisition is a purchase of the entire business, any and all tax charges are assumed by the purchaser. This is one of the areas covered by the indemnities from the seller, for which a hold-harmless agreement is usually drawn up.

¹ BIR Ruling No. 424-14 dated 24 October 2014.
Pre-sale dividend
While not a common practice, dividends may be issued prior to a share purchase. However, dividends are subject to tax, except for stock dividends received by a Philippine company from another Philippine company.

Transfer taxes
Transfers of shares of stock, whether taxable or as part of a tax-free exchange, are subject to stamp duty. Only sales of shares listed and traded through the Philippine stock exchange are exempt from stamp duty. As of 20 March 2009, the Republic Act 9648 permanently exempts such sales from stamp duty.

Choice of acquisition vehicle
In structuring an acquisition or reorganization, an acquiring entity or investor can use one of the entities described below. Since the tax implications for different income streams vary from one acquisition vehicle to another, it is best to examine each option in the context of the circumstances of each transaction.

Local holding company
A Philippine holding company may be used to hold the shares of a local target company directly. The main advantage of this structure is that dividends from the target company to the holding company are exempt from tax. Although distributing the dividends further upstream to the foreign parent company will attract the dividend tax, tax-efficiency may still be achieved through the use of jurisdictions where such foreign parent company is located. It is common to use a jurisdiction with which the Philippines has an effective tax treaty to optimize tax benefits.

One disadvantage of a Philippine holding company is that it attracts an improperly accumulated earnings tax (IAET). Under current law, the fact that a corporation is a mere holding company or investment company is prima facie evidence of a purpose to avoid the tax on the part of its shareholders or members. Thus, if the earnings of the Philippine holding company are allowed to accumulate beyond the reasonable needs of the business, the holding company may be subject to the 10 percent IAET.

Foreign parent company
Where a foreign company opts to hold Philippine assets or shares directly, it is taxed as a non-resident foreign corporation. A final withholding tax (WHT) of 15 percent is imposed on the cash or property dividends it receives from a Philippine corporation, provided the country in which the non-resident foreign corporation is domiciled allows a credit against the tax due from the non-resident foreign corporation taxes deemed to have been paid in the Philippines equivalent to 15 percent. Similarly, the tax rate may be reduced where a tax treaty applies, subject to securing a prior confirmatory ruling from the BIR. As noted earlier, all preferential rates and exemptions under a treaty apply only if a prior ruling is secured. This is still the prevailing rule under Revenue Memorandum Order No. 72-2010.

Philippine corporation law does not permit a foreign company to merge with a Philippine company under Philippine jurisdiction. However, they may elect to merge abroad.

Non-resident intermediate holding company
Certain tax treaties provide exemption from CGT on the disposal of Philippine shares. Gains from sales of Philippine shares owned by a resident of a treaty country are exempt from CGT, provided the assets of the Philippine company whose shares are being sold do not consist principally (more than 50 percent) of real property interests in the Philippines. Also, some treaties (e.g. Philippines-Netherlands tax treaty) grant a full exemption on alienation of shares without condition (i.e. without the real property interest component). This is a potential area for planning, and specific treaties should be consulted.

Local branch
In certain cases, foreign companies may opt to hold Philippine assets or shares through a branch office. As with a domestic corporation, the Philippine-source income of a resident foreign corporation, such as a branch, is taxed at the rate of 30 percent (from 1 January 2009). Through the attribution principle implemented under Revenue Audit Memorandum Order (RAMO) No. 1-95, a portion of the income derived from Philippine sources by the foreign head office of the branch is attributed to the branch, following the formula in the RAMO. The income is apportioned through the branch or liaison office that was not party to the transaction that generated the income. The branch or liaison office then becomes liable to pay tax on the income attributed to it. Profit remitted to a foreign head office is subject to a 15 percent WHT, unless reduced by a tax treaty.

In establishing a branch office in the Philippines, the SEC requires that the foreign head office comply with certain financial ratios (i.e. 3:1 debt-to-equity ratio, 1:1 solvency ratio and 1:1 currency ratio).

Joint venture
Joint ventures may be either incorporated (registered with the SEC as a corporation) or unincorporated. Both forms are subject to the same tax as ordinary corporations. Unincorporated joint ventures formed to undertake construction projects, or those engaged in petroleum, coal,
geothermal or other energy operations under a government service contract, are not taxable entities. Profits distributed by the joint venture or consortium members are taxable.

**Choice of acquisition funding**

Corporate acquisitions may be funded through equity, debt or a combination of the two.

**Debt**

Companies tend to favor debt over equity as a form of financing mainly because of the tax-favored treatment of interest payments vis-à-vis dividends (see this report’s information on deductibility of interest). The tax advantage of interest payments, in contrast to dividends, is an outright savings of 30 percent in the form of deductible expense against the taxable base. Since interest payments are subject to a 20 percent final tax under the Tax Code, financing through debt still has an advantage over financing with equity equivalent to 15 percent.

Currently, there are no specific rules for determining what constitutes excessively thin capitalization, so a reasonable ratio of debt to equity must be determined case-by-case.

**Deductibility of interest**

Under current law, interest payments incurred in a business are deductible against gross income. The allowable deduction for interest expense is reduced by 33 percent of the company’s interest income, if any, subjected to final tax.

**Withholding tax on debt and methods to reduce or eliminate it**

Generally, interest income received by a Philippine corporation from another Philippine corporation is subject to the regular corporate income tax of 30 percent. However, interest income received by a non-resident foreign corporation from the Philippines is subject to a final withholding tax of 20 percent. The rate of WHT may be reduced or eliminated under a tax treaty, subject to securing a prior ruling.

**Checklist for debt funding**

As no specific rules determine what constitutes excessively thin capitalization, a reasonable ratio of debt-to-equity should be determined case-by-case.

**Equity**

A purchaser may use equity to fund its acquisition by issuing shares to the seller as consideration.

A tax-free acquisition of shares can be accomplished through a share-for-share exchange between the acquiring company and the target company. In such an exchange, one party transfers either its own shares or the shares it owns in a domestic corporation solely in exchange for shares of stock in the other company, and the transferor gains control of the transferee company. In the same manner, the transferee company becomes the controlling stockholder of the transferor company since the shares received are the domestic shares of the transferee company.

This is considered a tax-free exchange within the scope of section 40(C)(2) of the Philippine Income Tax Code. No gain or loss is recognized if property (including shares of stocks) is transferred to a corporation by a person in exchange for stock or units of participation in such a corporation such that the person, alone or with no more than four others, gains control (stock ownership of at least 51 percent of the total voting power) of the corporation.

**Hybrids**

The current laws contain no guidelines on whether to classify hybrid financial instruments as equity infusions or debt instruments. The question is whether a loan is a bona fide loan or a disguised infusion of capital.

If it is the latter, there is a risk that the BIR may:
- disallow the interest expense
- where the loan is interest-free or carries an interest rate that is less than the prevailing market rate, impute interest income to the lender and assess additional income tax thereon.

Certain court decisions may provide some guidance on whether a transaction should be considered a bona fide loan or a dividend distribution. To date, no authoritative or definitive rulings have been issued.

**Discounted securities**

Under Philippine laws, the discount on discounted securities is treated as interest income rather than a taxable gain. For discounted instruments, a trading gain arises only where the instrument is sold above par.

**Other considerations**

**Concerns of the seller**

In an acquisition of assets, a sale comes within the purview of the Bulk Sales Law where it is a sale of all or substantially all of the trade or business, or of the fixtures and equipment used in the business. The seller must comply with certain regulatory requirements; if not, the sale is considered fraudulent and void.

VAT applies to sales of goods in the ordinary course of trade or business (i.e. the regular conduct or pursuit of a commercial or an economic activity, including incidental transactions). Thus, isolated transactions generally are not subject to VAT.
However, decisions of the Philippine Court of Tax Appeals in 2013 consistently hold that an isolated transaction may be considered an incidental business transaction for VAT purposes. Hence, VAT may be imposed on isolated transactions such as sales of assets, shares or the whole business enterprise.

**Company law and accounting**

The Corporation Code of the Philippines governs the formation, organization and regulation of private companies, unless they are owned or controlled by the government or its agencies. The Corporation Code also governs mergers and other business combinations.

The Corporation Code allows two or more corporations to merge into either of the constituent corporations or a new consolidated corporation. Under the Philippine Tax Code, the terms ‘merger’ and ‘consolidation’ are understood to mean:

— an ordinary merger or consolidation
— the acquisition by one corporation of all or substantially all the properties of another corporation solely for stock, undertaken for a bona fide business purpose and not solely for the purpose of escaping the burden of taxation.

Mergers in the Philippines require a transfer of all the assets and liabilities of the absorbed corporation to the surviving corporation. This step is followed by the dissolution of the absorbed corporation. In return for the transfer of all the assets and liabilities of the absorbed corporation, the surviving entity issues a block of shares equal to the net asset value transferred. These shares are in turn distributed to the stockholders of the absorbed corporation.

A de facto merger is the acquisition by one corporation of all or substantially all of the properties of another corporation solely for stock, usually undertaken for a bona fide business purpose and not solely for the purpose of escaping the burden of taxation. These methods are:

— comparable uncontrolled price method
— resale price method
— cost plus method
— profit split method
— transactional net margin method.

The guidelines recognize the authority of the Commissioner of Internal Revenue to make transfer pricing adjustments to ensure that taxpayers clearly reflect income attributable to related-party transactions and to prevent the avoidance of taxes with respect to such transactions.
The documentation supporting the transfer pricing analysis is not required to be submitted upon filing of tax returns. The taxpayer should retain the documentation for the period provided under the Tax Code and be prepared to submit to the BIR when required or requested to do so.

Further, the documentation should be contemporaneous (i.e., existing; prepared at the time the related parties develop or implement any arrangement that might raise transfer pricing issues, or prepared when the parties review these arrangements when preparing tax returns).

**Dual residency**

The Philippines follows the incorporation/domestication rule: a corporation is considered a resident of the country where it is incorporated. Certificates of incorporation or registration and articles of incorporation or association are considered sufficient proof of residency.

**Foreign investments of a local target company**

Philippine domestic corporations are taxed on their worldwide income at the rate of 30 percent, subject to foreign tax credits in compliance with applicable rules.

**Comparison of asset and share purchases**

**Advantages of asset purchase**

— The transferee corporation does not automatically assume liabilities of the transferor corporation.

— The transferor corporation does not automatically dissolve and may continue its separate existence.

— The transferor and transferee corporations may select which assets to transfer or purchase.

— The transfer of all or substantially all of the assets solely for stock is not subject to donor’s tax.

— The transfer of all or substantially all of the assets solely for stock is not subject to stamp duty unless the assets transferred involve real property.

— No loss or gain is recognized, provided the conditions in section 40(c)(2) of the Tax Code are met.

— An asset purchase does not normally need SEC approval, unless the assets are payments for subscription to the capital stock and there is a need to increase the authorized capital stock of the transferee corporation.

— The property purchased by the buyer is subject to depreciation. The buyer may use a different method and rate of depreciation based on the acquisition cost of the property acquired.

**Disadvantages of asset purchases**

— Unless specifically provided for in the agreement, the transferee corporation does not acquire the rights, privileges and franchises of the transferor corporation.

— The transferee corporation cannot claim any NOLCO of the transferor corporation since the transferor corporation continues to exist as a legal entity.

— The transferor’s unused input VAT cannot be absorbed by or transferred to the transferee corporation.

— A transfer of all or substantially all of the assets must comply with the requirements of the Bulk Sales Law.

— A higher purchase price arises in the event of any additional premium or goodwill imputation.

— Acquisition is subject to VAT where the transaction is deemed to be a sale.

— Any real property purchased is subject to stamp duty and VAT.

**Advantages of stock purchase**

— The buyer may benefit from an automatic transfer of the rights, privileges and franchises by the transferor corporation to the transferee corporation.

— The transferee corporation may claim the NOLCO of the transferor corporation, subject to the provisions of the Tax Code and its regulations. However, in 2012, the BIR ruled that in a statutory merger, the NOLCO of the absorbed corporation is not one of the assets that can be transferred and absorbed by the surviving corporation, as this privilege or deduction is only available to the absorbed corporation. Accordingly, the tax-free merger does not cover the NOLCO of the absorbed corporation that can be transferred and absorbed by the surviving corporation.

— The transferor’s unused input VAT may be absorbed by or transferred to the transferee corporation.

— A merger may not be subject to donor’s tax and VAT, subject to the comments above. Moreover, no loss or gain is recognized, provided the conditions in section 40(c)(2) of the Tax Code are met.

— A stock purchase may involve a lower purchase price and lower taxes.
Disadvantages of stock purchase

— The transferee corporation may be responsible for all the liabilities and obligations of the transferor corporation as if the transferee corporation had incurred them directly. Any claim, action or pending proceeding by or against the transferor corporation may be prosecuted by or against the transferee corporation.

— It may be necessary to increase the authorized capital stock of the transferee corporation to accommodate the issue of new shares; hence, SEC approval is required.

— The issue of new shares is subject to stamp duty.

— Regulatory compliance would be required before the shares are registered in the buyer’s name.