Transfer pricing and mergers and acquisitions in Africa

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Tax Alert

As a result of competitive pressures, the current global economic conditions and advancements in technology, multinational enterprises (MNE) are often forced to adapt their business by acquiring or merging with other companies to remain competitive or grow their business.

Mergers and acquisitions (M&A) have long been a key element of growth strategy for MNEs. There are various benefits of M&A. M&A activities enable MNEs to generate cost efficiencies through economies of scale. It can also create an expanded presence by entering new geographic territories or enhance revenue through gains in market share. The period following an M&A deal, is the opportune time to enhance shareholder value. Through successful tax and transfer pricing planning the future of the deal may bring a host of opportunities but might also create additional risks.

Despite the global economic conditions, Africa's growth is escalating and drawing attention from MNEs that are seeking growth in emerging markets. MNEs, over the past few years, are prepared to make substantial investments into Africa, through skills development and funding. The MNEs also look for equity investments depending on the particular local circumstances and requirements relating to local investment. The mix of debt and equity is a fine balance that needs to be struck, often having regard to the particular tax consequences of withholding taxes payable on either dividends or interest.

Not only is transfer pricing an integral part of any M&A transactions, it should also be considered during the pricing, due diligence and post transaction phases. M&A transactions provide MNEs with the opportunity to re-evaluate historical positions and policies that may be harmful to the company due to an overly aggressive tax position. Throughout the due diligence phase it might become apparent that the structuring of the transactions is too complex or impossible to enhance the future viability of the company.

Pricing

Price is the total amount of consideration paid in all forms in order to acquire the company or substantially all of its assets. The seller is going to want to walk away from the table with the highest price it believes is obtainable, plus as much cash as possible, the least tax burden and no additional risk. The seller, however, would like to pay one level of tax, preferably at the capital gains rates. The seller wants to sell stock because it avoids any potential issues with double taxation and allows him or her to walk away from the deal with no exposure for the acts of the past (except as may be defined by the purchase agreement). If the acquisition is structured as an asset purchase, the seller will want an allocation that avoids or minimises the recapture of depreciation.

On the other hand, the buyer wants the best price, maximum deduction of the purchase price, favourable purchase terms and for the seller to have a vested interest in the future in the form of a deferred or contingent payment. Generally, a buyer will want to purchase assets because it more specifically defines what is and what is not being purchased. In a stock acquisition, you get everything including contingent or unforeseen liabilities.

To come to a price that will satisfy both the buyer and seller, will entail a thorough review of historical financial results, an assessment of the prospect of future market opportunities, and a valuation of the probable cost synergies as a result of the business amalgamation.

Due diligence

A due diligence is the process of evaluating a prospective business decision by getting information about the historical financial results, legal documentation and any other material issue of the other MNE.

Due diligence is used most often when buying a business, as the buyer spends time going through the financial situation of the business, legal obligations, customer records, and other documents. The prospective buyer wants to assess the potential for any unrecorded liabilities that he/she might assume once the transactions has been finalised. Transfer pricing is one such an unrecorded liability that necessitates a very close look at during the due diligence phase.

We have seen numerous companies (mostly from the sales side) trying to justify during the due diligence phase that their international transactions are of an arm's length nature. The justification could have been valid were these companies in a position to demonstrate such through proper documentation, that is a transfer pricing report with sufficient economic backing, encapsulating all the functions performed, risks assumed and asset utilised by them, as well as proper legal documentation.

A transfer pricing specialist could assist the buyer in conducting a review of the seller company's current and past transfer pricing practices, and reach an independent result of the potential transfer pricing liability and the implications for the overall valuation.

With Africa's current and potential growth, we have seen increased scrutiny of intercompany pricing from tax authorities across Africa. This has resulted in a number of assessments on proposed adjustments made by tax authorities. In South Africa, we are aware of numerous transfer pricing settlements amounting to hundreds of millions of rands. Accordingly, if the potential transfer pricing liability is not quantified during the due diligence phase, the buyer would be forced to settle these disputes with the tax authorities. The end result thereof might be crippling to their business existence.

Post deal integration

The period following the completion of a transaction (post-deal) may prove to be a sensible time to relook at the current business model. This might be the ideal time to restructure the business or look at synergies within the company's manufacturing, supply chain and procurement functions to maximise profit which might not be available under normal circumstances. The coming together of two companies will also mean that a new transfer pricing policy be drafted to ensure that it recapture the coming together of the functions performed and risks assumed for the standalone company.

If done correctly, it might result in tax and cost savings and a more streamlined business model. To streamline the business it might be possible to implement a supply chain management strategy, such as centralising the procurement functions, warehousing, integrate the sales team and product logistics functions. Intercompany services might also be streamlined by setting up a shared service centre to ensure cost efficiency and consistency, or by mere centralising the research and development, management services and quality controlled activities.

The period following a strategic business action, such as M&As or even divestures, is an essential time to update the current transfer pricing documentation to ensure that it recaptures the coming together of the functions performed and risks assumed for the newly formed company.

Closing

Taking the time to involve tax and transfer pricing specialists in any M&A transaction might not only determine the correct pricing or establishing future risks, it might actually help companies re-look at their strategies and streamlining their processes to a more efficient and effective company with future growth and a sustainability that will enhance shareholder value.

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