

## Consolidation in the pharmaceutical sector – practical aspects to be remembered when merging/acquiring a company – part II

M&A transactions play a significant role in increasing the level of growth in the worldwide pharmaceutical sector. But about 70% of all such deals fail to provide the anticipated benefits. Both tax and legal aspects must be taken into consideration if you like to avoid being among the failed business marriages.

### Tax aspects

In this part of the article we are not elaborating on all the most beneficial structures (from the tax point of view) to be implemented when executing an M&A transaction. Every case is specific and our experience shows there is no general rule to be followed in every transaction. According to specific circumstances, a pure merger (either in the form of a combination of two separate entities into one company or integration of the target entity into the surviving company) appears the best and most efficient option for one M&A transaction, while it happens to be the worst scenario for another transaction.

We would like to focus here on two (or in fact three) practical aspects that appeared in our practice, caused some controversies and exposed the M&A transaction to tax ineffectiveness (in other words – the total cost of the transaction could substantially increase).

### Refund of the input VAT

The VAT rate applicable to trade in pharmaceutical products in Poland amounts to 7%. At the same time, most of the purchases are made with 22% VAT as input VAT to be deducted. This means that the excess of input VAT against output VAT is regularly declared by pharmaceutical companies in their monthly/quarterly VAT settlements.

When an M&A transaction is finalised – let's assume for the purpose of the article that we are having only one surviving company after the deal, while the target ceases to exist – the question appears who is entitled to receive the refund of the input VAT after the M&A transaction. Is it the target company? How? This company does not exist anymore and there is no legal entity to apply for the refund. Still, however, the excess of input VAT was declared by the target company in the VAT return for the last month before the M&A transaction was finalised.

According to rules governing general succession of rights and obligations (based on the Tax Code – art. 93 as well as the Code on Commercial Companies – art. 494) – the surviving company is fully entitled to technically “acquire” the input VAT declared by the target entity in the last VAT return before the merger transaction. Such an approach is also confirmed by tax authorities in issued interpretations.

### Settlement of expenditures

The other practical issue that appeared in our practice related to the settlement of expenditures (e.g. marketing) of the target in the period before the M&A transaction is finalised. Among many possible cases there are two situations that trigger some controversies regarding proper tax settlement (from the corporate income tax perspective):

- The service (marketing activity) was actually performed before the transaction while all the settlements (invoicing, payments) are made after the transaction date. This situation essentially creates a split between execution and financial clearance (the transaction date represents the point of split).
- The service was actually performed before the transaction, the invoice was received while the payment remained to be made after the transaction date.

In both situations the vital question arises – which entity is allowed to declare the cost of the marketing activity in its books – either the target (for the period before the transaction) or the surviving company (for the period after the transaction date). Naturally, we assume here that all the costs we are discussing – as a rule – are tax deductible.

As the first step when answering the questions, we have to decide what kind of costs (from the corporate income tax perspective) we are analysing – namely – direct or indirect. As a rule – marketing services shall constitute indirect costs. Of course, this is not applicable when we are talking about a marketing company separated within the group – which means that the core business of the company covers the provision of marketing services for the benefit of other entities in the group.

Having all that in mind, according to corporate income tax regulations all indirect costs are tax deductible as incurred. There was a discussion for many years as to when the cost is deemed to be incurred. A few years ago the controversies were settled, as the law explicitly states that an indirect cost is incurred as of the day when it is booked for accounting purposes. This means that in our cases (presented at the beginning) – in the first situation the cost could be deducted for tax purposes by the surviving company (as it would only be possible to book the cost in its books), while in the second case – the cost would be deducted in the books of the target company, although it is supposed to be paid by the surviving company.

### The devil is in the details

Instead of a summary, we would like to briefly describe a case that illustrates why the devil is in the details. Once upon a time in

Poland there was a merger of two companies – let's assume that company A was a huge distributor generating impressive revenues and – profits. Company B was a small producer with substantial potential, unfortunately, generating tax losses for recent periods. Stakeholders agreed to merge these two companies. For the executives of company A it was natural that A had to remain the surviving entity (bigger, impressive profits comparing to B – smaller, tax losses).

We know and everybody on the market is saying that mergers are tax neutral. No taxable revenue created from the corporate in-

come tax perspective (no tax to be paid), no VAT liability exists. This is true. Absolutely. The companies merged as planned with the support of a group of lawyers. One thing was missed, unimportant at first glance, but causing an additional cost for the transaction. The corporate income tax law stipulates that in the case of a merger – only losses of the surviving company could be carried forward. This meant that – in our case – all the losses that could be offset against the profits to be generated after the transaction and thus – decrease the tax liability due after the deal – were lost...

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A D V E R T I S I N G

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