



What's new! In M&A TAX

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What's new! in this edition

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PwC Brazil M&A Tax team is pleased to announce What's new!

By Rodrigo Bastos, M&A Tax Partner and Private Equity Tax Leader in Brazil

In an environment like ours, where the tax and labor legislations are quite complex and subject to multiple interpretations and the final outcomes in court may take a long time, the tax and labor issues have a dramatic impact on Mergers and Acquisitions. The experience of our PwC M&A Tax team, fully dedicated to deals transactions, reveals that, more than 90% of the deal breakers are tax and labor related.

In this context, **What's new!** brings short articles produced by our M&A Tax professionals involved in the development of acquisition structures, tax and labor Due Diligences and Post Deal Integrations, among other solutions, and share our professional experiences as well as market views of M&A players doing deals in Brazil.

In this very first Edition, **What's new!** calls the attention to Tax M&A hot topics such as the goodwill tax amortization, the extended tax substitution methodology adopted in the State of São Paulo and the new federal special installments program (the "Crisis REFIS").

New deals, new rules for goodwill

By Fábio Dantas, Senior Manager – M&A Tax

In December 2007, the Brazilian Congress approved Law 11638/07, which represented an important update of the Brazilian Corporate Law as it relates to accounting standards. As the main goal of this new Law is to transition Brazilian GAAP toward IFRS, such changes would have implications on M&A processes and specially with regard to goodwill amounts paid under acquisition structures.

The application of these new accounting rules for M&A processes involving the payment of goodwill amounts is regulated by a recent rule (the Deliberation 580 - CPC 15), issued by the Brazilian Securities Commission (CVM) on July 31, 2009.

In summary, according to such new accounting rule, the amount paid for the acquisition of Brazilian companies should be allocated, at the level of the acquiring company, to the fair market value of the assets (tangible or intangible) or liabilities for which the purchase price was paid. The difference between such allocation and the total amount paid for the acquisition of interest in the Brazilian company should be classified, for accounting purposes only, as goodwill. This rule is mandatory only for M&A transactions taken in place as from December 2010.

The main change already in force regards the rule in which the goodwill paid on the acquisition of Brazilian companies is no longer amortized at the level of the Brazilian acquiring company but is instead subject to annual impairment testing.

The impairment, if it occurs, cannot be reversed in the future and is not deductible for local tax purposes. Therefore, the impairment can affect the acquiring company's net equity and, consequently, the outflow of dividends arising from the acquired (and operating) company. This rule is applicable since January 2009.

The implications mentioned before are valid only for accounting purposes. For tax purposes, the current Brazilian Legislation establishes that the new accounting rules shall not increase a company's tax burden and responsibilities (at least for a while).

Hence, in theory, the tax benefits derived from the payment of goodwill for the acquisition of Brazilian companies are still in force.

After the merger between the acquiring and acquired companies and provided that some relevant conditions are met - one of them being to provide evidence that the acquisition structure has been established with consistent business purposes and not with the sole purpose of avoiding taxation in Brazil - the goodwill amount may continue to be deducted for local tax purposes.

The tax authorities are already discussing potential changes with regard to the tax treatment related to the tax deductions arising from goodwill paid in acquisition structures. This means that there may be changes for local tax purposes in the future. In this case, the tax benefit could be reduced (because of the potential adoption of the IFRS methodology) or even eliminated by the new law to be issued.

Indeed, considering that we are in August 2009, it is unlikely that any change will be valid for 2010. However, acquisition structures where the merger between acquiring and acquired companies has already been carried out, would be more protected in the case of any future changes in the local tax rules, disallowing or reducing the ability to deduct the goodwill.

In any case, the potential reduction in the tax benefits arising from goodwill deductions would correspond, in principle, to lower purchase prices to be paid for Brazilian assets. Consequently, less capital gain to be earned by the seller and taxed upfront in Brazil. In other words, under the local tax authorities perspective, except for income tax rate differences and timing issues, any tax impact of the goodwill legislation, in general, would not affect future tax revenues.

The new tax payment in installments program – “The Crisis REFIS”

By Hélio Almeida, Senior Manager – M&A Tax

There is a new tax installments program for federal taxes available in Brazil. The “Crisis REFIS” (issued by the Law 11941/09), allows federal tax debts up to November 30, 2008 to be paid in 180 installments.

The debts related to Brazilian Excise Tax (called IPI), not paid due to the adoption of the tax position according to which IPI tax credits could be taken on the acquisition of inputs and raw material subject to “zero rate” (such position was recently rejected by the Brazilian Supreme Court), as well as the tax debts already included in other payment in installments programs for federal taxes (REFIS, PAES and PAEX for instance), may be enrolled in this new payment in installments program.

The good news arising from this new program refers to

- I. the fact that taxpayers can determine which tax debts (or parts of tax debts) they may desire to have included in the program;
- II. the penalties, interest and legal charges levied on the referred tax debts can be significantly reduced for shorter periods for installments (they can be reduced in 100%, if the tax debt is paid upfront – except for REFIS, PAES and PAEX for which the maximum reduction is 40%) and;
- III. the amount of tax debts included in such payment in installments program can be settled using the company's NOLS amount at a 34% rate.

Also, the revenues corresponding to the eventual reduction in the penalties, interest and legal charges shall not be subject to Brazilian Income Taxes (IRPJ and CSLL – at a combined 34% rate) or the Brazilian Taxes on Revenues (PIS and COFINS – at 9.25% combined rate).

Judicial deposits made by a company may also be used in order to reduce tax debt amounts considered under this new program.

Detailed conditions and formal procedures for the program were issued by the Brazilian Tax Authorities in July 22, 2009 (“Portaria Conjunta PGFN/RFB 6/09”).

Among other conditions, it is established that (i) taxpayers should give up any litigation related to the tax debts to be included in the program; (ii) monthly tax installments should not be lower than Brazilian R\$ 2,000, in the case of the IPI and; (iii) the minimum monthly tax installments regarding other installment programs (REFIS, PAES and PAEX) should correspond to 85% or to the average of those installments paid in the last 12 months.

The key message arising from such new program is that it may represent a significant asset or price appreciation in the context of M&A transactions for the reason that it may provide an important alternative for the reduction of a company's tax contingencies and/or an opportunity for a company to reconcile and duly register its tax exposures in more favorable conditions.

This may be a good occasion to reconsider deals which have not taken place due to tax exposures and/or to reassess companies in which tax contingencies represented a significant decreases in net value.

Furthermore, this installments program may be used by companies under bankruptcy or financial recovery as it may represent an important relief on their tax debts. In the post-deal phase, for instance, such program may change the scope of due diligence follow-up procedures and drive cash resources to the productive areas of the investee, rather than to paying taxes.

ICMS tax substitution in São Paulo

By Marcos Tabatschnic and Rita Canto, Managers – M&A Tax

Recently, the State of São Paulo has been increasing the number of industries which are subject to the ICMS tax substitution regime such as cosmetics, personal hygiene products, certain alcoholic beverages and paper industries.

The ICMS (State VAT) tax substitution regime is based on a single ICMS taxation of the goods over the whole chain, instead of the taxation of each phase. As a general rule, the tax substitution regime is applied at the beginning of the chain.

The most usual method applied in order to estimate the calculation basis of the ICMS tax substitution is the "value added margins", determined by the Tax Authorities, which presume the profit margins applied until the end of the chain.

However, such presumed profit margins very often are higher than the actual margin applied in the whole chain. This discrepancy may impact the cash flow and the profitability of the companies, as the ICMS tax previously paid by the substitute taxpayer will be charged in the price and not rarely it will be higher than the one that would be paid in the normal regime of taxation.

In this moment of economic crisis, the frequently higher value-added margins established by the Tax Authorities increase the total tax burden of the companies as it is not possible to consider in the final product prices the corresponding increase of taxation derived from the substitution regime above.

There are impacts on the substitute taxpayer as well. Despite the fact that the tax previously paid will be charged from the subsequent companies in the chain, such taxation regime may also impact its cash flow, as the tax in most cases is paid in advance.

Until December 2008, São Paulo tax legislation determined that, if the final sales price was higher or lower than that effectively used to calculate the ICMS tax substitution, it was necessary to calculate and pay the complement or claim the reimbursement of the difference. As of January 2009, the tax substitution payment is considered final (no complement payments is required or reimbursements made).

Therefore, if the final price to the consumer is lower than that assumed to calculate the ICMS tax substitution, the impossibility to reimburse the difference also contributes to the increase in the tax burden of the companies. Due to those changes, many companies decided to claim in court the reimbursement in case of over-taxation of goods.

In a M&A transaction, the increase of the tax burden as a consequence of the tax substitution regime might impact the profitability of the target company and as a result the EBITDA might be significantly reduced. It is also necessary to review and test the procedures adopted by the target company, as the tax substitution regime has very complex rules and miscalculations or erroneous procedures adopted could lead to significant contingencies.

We will be glad to hear from you. Please let **What's new!** have your comments, suggestions and ideas. E-mail to fabio.dantas@br.pwc.com or rita.canto@br.pwc.com

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