Corporate Tax

First Edition

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Tax implications of leveraged buy-out structures in Turkey

A leveraged buy-out ("LBO") is defined as an acquisition of a company ("Target") financed largely with debt, where generally a small amount of capital is allocated. High leverage is crucial in LBO transactions because of lack of adequate capital to finance such acquisitions. Many cases show that debt financing also helps the leveraged company (the "Buyer"), by enabling it to benefit from certain tax reliefs. LBO transactions are especially favoured by private equity funds.

In LBO transactions, investors look for high returns on equity investments and wish to benefit from financial leverage to increase potential returns. Therefore, the Target must have strong and predictable operating cash flows by which the leveraged Buyer can pay down its acquisition debt.

In order to achieve this, the Buyer's indebtedness is transferred to the Target generally through a merger operation following the acquisition. This transaction is characterised as a "leveraged buy-out merger" whereby consequently the acquisition is directly sponsored by the Target. Such a leveraged buy-out merger takes place where either (i) the Target is merged into the leveraged Buyer (upstream merger), or (ii) the leveraged Buyer is merged into the Target (downstream merger).

Following such a merger, the surviving company then seeks to deduct the financial expenses (interest and foreign exchange losses) arising from the financial leverage utilised by the Buyer. Due to the fact that the debt is pushed down into the surviving company, financial expenses relating to such are used to offset revenues generated by the merging Target. Therefore, acquisition of the shares of a Target with substantial debt is also described as a "debt push-down strategy" by the Buyer.

There was an explosive growth in LBO transactions in the 1970s and early 1980s due to high returns first experienced in the market. After a decline in the early 1990s and in the recent past, LBOs are once again on the rise today, although in somehow different formats. As a result of more regulated financial environments, LBOs today involve less leveraged capital structures, are subject to more intense competition, and result in lower returns.[1]

The controversy about LBO structures around the world (tax benefits)

One of most controversial issues about LBO structures involving subsequent mergers has been the taxation of the surviving company, in which the leveraged Buyer and the Target are merged.

Tax authorities across the globe have had a longstanding negative approach towards LBO transactions. In their view, the financial expenses resulting from loans to finance the acquisition of shares of the Target should not be deductible for corporate tax purposes by the surviving company. Accordingly, LBO transactions constitute abusive tax practice to the extent that the transfer of the shares of a Target followed by a merger is exclusively aimed at reducing the Target's taxable income by increasing its financial liabilities deriving from the acquisition transaction.

Tax authorities posit that there is no economic and commercial reason for choosing such a structure other than tax evasion, since the same economic result, i.e making the investment to the Target, could be achieved via direct investment to the Target rather than an investment via a leveraged Buyer acting between the main investor (parent company of such Buyer) and the Target.

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Consequently, where the tax authorities deem that the main aim of a specific LBO transaction is to abuse tax advantages as stated above, they reject it. Increasing numbers of countries adopt strict anti-abuse rules so that taxpayers setting up controversial structures, such as the LBO structures, must prove substantial non-tax reasons (valid business and commercial considerations).

First LBOs in Turkey and accommodating changes in the Turkish legal environment

LBOs first became an attractive option in the early 2000s for foreign investors acquiring Turkish state-owned, as well as privately held, companies, following the Turkish government's intense privatisation programme, and policies supporting foreign investment.

The initial LBOs in Turkey mainly involved the following two steps:

The first step was the setting up of a new Turkish capital company (as the Buyer), which is to be financed mostly by debt and partially by equity subscribed by the parent company investor. Such debt financing, generally coming from a third party bank loan instead of a shareholders' loan, was used to acquire the shares of the Target (i.e. Turkish state-owned or privately held companies) whereby the Target would become an indirect subsidiary of the parent company investor.

The second step was to merge the Buyer into the Target (a downstream merger) or, alternatively, to merge the Target into the Buyer (an upstream merger) by a merger operation. As a consequence of the merger, the debt of the Buyer would be pushed down into the Target, resulting in a deduction of interest expenses and foreign exchange losses of the Buyer from the profits of the Target. Thus, the Target would become a less profitable company and declare a lower corporate tax base. Thereby, the interest expenses arising from the loans used for the acquisition of the shares of the Target would mainly be financed by tax reliefs.

Then on 1 January 2006, a new corporate tax law numbered 5520 ("Turkish Corporate Tax Law") came into force as a result of a conscious step by the Turkish government to legally regulate LBOs so as to incentivise the privatisations of state-owned companies. Some leading acquisitions have been realised through LBO structures in Turkey under the regime of the Turkish Corporate Tax Law, as explained below.

The Turkish Corporate Tax Law clarified for the first time that the financial expenses of a company related to the purchase of participation shares (the shares of the Target) are to be regarded as deductible expenses in determining the corporate income tax base. Prior to the Turkish Corporate Tax Law, deductibility of financial expenses incurred as a result of acquisition of shares of the Target was one of the vague areas of Turkish tax practice, mainly stipulated in the official opinions of the Ministry of Finance as well as decisions of the Council of State[2].

The Turkish Corporate Tax Law numbered 5520 also introduced *laissez-faire* new rules about the transfer of losses of the dissolving companies in a tax-free merger operation (mainly referred to as a "takeover") to the surviving company.

Brought in with the Turkish Corporate Tax Law, these two regulations allowed the Buyer and the Target to be merged in such a way as to have the losses and the financial expenses of the Buyer derived from financing of the acquisition of the shares of the Target transferred to the surviving company, the Target or the Buyer as the case may be, as a deductible loss provided that certain conditions under the Turkish Corporate Tax Law are met.

Accordingly, the Turkish Corporate Tax Law allows that the losses of the dissolving company, not exceeding the amount of its equity as of the date of the merger, may be deducted when determining the corporate tax base of the surviving company, if the following two conditions are met:

- corporate income tax returns of the dissolving company for the last five years have been filed on time; and
- the surviving company must continue to conduct business operations of the dissolving company at least for five years following the date of the merger.

Controversial approach of the Turkish tax authorities towards LBOs

Despite the accommodating legal environment brought along with the Turkish Corporate Tax Law,

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Turkish tax authorities have issued tax assessment reports criticising the LBO structures.

The said tax assessment reports criticise the LBO structures mainly as follows:

- Where the Target, which is an operating company generating a considerable amount of profit, and the Buyer, which is a company (i) having no business operations other than being a shareholder of the Target, (ii) carrying huge financial debt relative to its small equity, and (iii) generating large amounts of losses, merge and, upon completion of the merger, the Buyer gets the opportunity to offset its losses against the Target's profit, the result is that lesser corporate tax is paid by the surviving company.
- Such a merger followed by an LBO cannot have an economic rationale, since there can be no economic or business consideration other than aggressive tax planning to bring a subsidiary and the shareholder, being the Target and the Buyer as qualified above, into a mutually beneficial situation.
- Since "the principle of substance over form" shall be the main concern in evaluating tax-related issues, a merger following an LBO should not be protected under the provisions of the Turkish Corporate Tax Law regarding "tax-free merger operations". It should be acknowledged that such a merger is, in effect, a balance sheet consolidation between the Target and the Buyer, i.e. tax grouping between related companies, which is not allowed under Turkish tax laws. The operation is done with the sole motivation to reduce the tax burden of the Target and the Buyer.

Critique of approach of the Turkish tax authorities

The approach of the Turkish tax authorities can be criticised in the following ways:

- Turkish corporate tax law, while regulating tax-free merger operations of companies, has not imposed a condition that all companies taking part in the tax-free merger operation should be operational, active and profitable companies and that a tax-free merger operation should be based on an economic rationale.

  Turkish corporate tax law stipulates that the Target's losses, not exceeding its equity, can be deducted from the Buyer's profits to the extent that (i) corporate tax returns for the last five fiscal periods were duly submitted, and (ii) the commercial activities of the Target are continued for at least five years by the Buyer, thereby imposing no obstacles to offsetting losses of companies fulfilling such conditions.
- Even the interest payments and foreign exchange losses of a company arising from bank loans, which have been received to purchase the shares of the Target, are specifically regulated as deductible expenses for corporate tax purposes under the Turkish Corporate Tax Law.

  A merger of two companies duly made under the Turkish Commercial Code cannot be interpreted solely as a balance sheet consolidation for tax abuse purposes.
- The Council of State rendered consistent decisions in the past regarding the deductibility of losses of the dissolving company from taxable income of the surviving company in a merger, due to the principle of "full subrogation". In case of a tax-free merger, the principle of full subrogation will apply as well, since all liabilities similarly pass through to the surviving company, allowing the surviving company to exercise the right to offset its losses and deduct the expenses from its profits.

  In the absence of general anti-avoidance rules, those who wish to set up LBO transactions shall not legally be obliged to prove substantial non-tax reasons for their corporate structures, and there shall be no legal basis to avoid such structures, provided that they are compliant with current tax and commercial legislation.
- Lastly, the new provisions of the Turkish Commercial Code, which came into force in July 2012, allowing mergers of insolvent companies or companies under liquidation with good standing companies, may create an even more adequate legal basis for such tax-free merger transactions.

* * *

Endnotes

1. Figueira, Joao Gil; Leveraged buy-out finance structures, International Law Office, February 27, 2013.
2. The Council of State is the Supreme Court finally resolving tax disputes in Turkey.

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