

Accounting and tax issues in terms of the merger through absorption

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Abstract: *In a time when economies are more and more globalized, more inter – connected and facing economical – financial issues that tend to spread in a fast and even violent manner, with an impact on all social – economic levels of society, economic agents are searching for solutions in order to deal with this particular type of difficult situations, or even to survive. The present paper aims at revealing some of the accounting and tax issues in terms of the merger through absorption in the case of two private entities, as a business restructuring solution, in view of reaching a more compact and more efficient management of the latter.*

Keywords: *merger, absorption, net accounting assets, exchange ratio, overall assets*

Foreword

“It is in crisis that inventions are born, alongside great discoveries and strategies. It is the one who overcomes the crisis who actually goes beyond his very own limits, without remaining «rusty». Whoever finds crisis to be guilty of his failure is actually threatening his own talent and skills and pays more respect to problems than he shows to solutions. The real crisis is that of being incompetent” (Albert Einstein).

The need to cut down on expenses and the acute lack of liquidities which is even more seriously felt in a period of crisis, are the ones to determine small and large groups of companies to search for solutions in view of re – organization of the business activity the latter run. Part of the solutions the latter turn to in such difficult times is also represented by the reorganization of the business activity through merger or division. By means of a merger, one may restructure, reorganize and gain more efficiency in terms of the managerial decision process, given the acquired professional and managerial expertise.

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Such merger can provide for a more efficient use of human, material, logistic and informational resources of the above mentioned companies. At the same time, one such merger can lead to an increase of the entity having resulted, in its relationship with suppliers, with clients or with other financial and credit institutions. As a consequence of one such merger, one may implement a better business marketing policy, one may increase the retail capacity as well as the sales level, which shall also implicitly trigger a certain increase in terms of benefits. *An important effect of the merger is to reduce the considerable administrative cost and operational implications on the profitability of the company, which will lead to increased investment own financing sources* (Baba, 2012). The analysis carried out within the present paper aims at highlighting the main accounting and tax issues, as well as the methodology whereby one accomplishes the merger through absorption between two private entities, this being one of the most frequently met business restructuring processes within the groups of companies having a joint shareholding.

In the trading companies, the perception of the taxation–accounting relationship is strongly influenced by the managers’ concern to increase the investments’ efficiency and to lower the costs. (Anton, 2011).

1. The legally regulated stages of the merger through absorption

From a legal perspective, the merger and division operations are regulated under the Law no. 31 / 1990 on private entities, as republished, with the latter’s subsequent amendments and adjustments. By virtue of the Order of the Minister of Public Finance no. 897/2015 of societies, and withdrawal or exclusion of code shareholders companies, these operations are regulated in a very detailed manner both from a legal and also from a tax and accounting perspective, including a series of monographic examples.

The merger of two or several companies may be accomplished in compliance with the legislation in force, by one of the following two methods:

- by absorption, when one company gets the full patrimony of one or several companies, which shall thus terminate the latter’s business existence.

- by amalgamation, when two or several companies’ patrimony shall be transferred into the newly incorporated company’s patrimony.

In general, mergers tend to occur within a certain group of companies; however this does not stand for a prerequisite. One such merger shall be followed by the dissolution with no wind – up of the absorbed companies, which shall thus terminate the latter’s business existence. The stages that one goes through in order to accomplish such merger through absorption are:

- 1) The inventory and assessment of the assets and liabilities of the merging private companies, followed by the registration of the results of such inventory and of such assessment, as conducted upon such mergers.

- 2) The drawing up of the Financial Standings prior to such merger, by the companies which are to merge. Based upon the balance sheet drawn up prior to such merger, one shall determine the net accounting assets, according to the following calculation formula:

$$\text{Net accounting assets} = \text{Total Assets} - \text{Total Liabilities.}$$

- 3) The overall assessment of the companies in view of one's determination of the net contribution. For the purpose of evaluating the merging companies, one may use any of the following methods:

- the patrimonial method or the net assets method
- the stock exchange method
- the results – based method (profitability ratio , efficiency ratio, over – profit ratio)
- mixed methods

- 4) Determination of the exchange ratio of the shares or social parts to be issued in order to cover the absorbed companies' registered capital.

- 5) Determination of the number of shares or social parts to be issued for the remuneration of the net merger contribution.

- 6) The display in the companies' bookkeeping of those operations having been conducted upon such merger.

From a legal perspective, the new structure having resulted from the merger shall be implemented by one single set of documents, which shall include all the associates' rights and obligations.

For example, we shall hereby consider two private companies sharing a joint shareholding and wishing to merge through absorption, as follows:

- The absorbing company: SC Alfa SRL
- The absorbed company: SC Beta SRL
- The effects of the merger shall occur by virtue of art. 242 of the Civil Code and of art. 249 of Law no. 31/1990, upon the registration of the Decision of the last General Meeting which shall approve the respective merger.
- The assets and liabilities of each of the companies taking part in the merger have been inventoried and for each of them the reference Balance Sheet that is relevant for the said merger as of 31.12.2015, in compliance with the accounting balance concluded on the same date was drawn up.
- The merger shall occur by means of the full transfer of the absorbed company's patrimony to the absorbing company.
- The absorbing company shall acquire the rights and shall be held liable for the obligations of the absorbed company.
- The overall assessment of the companies has been carried out by using the patrimonial method.
- The patrimony of the companies taking part in such merger is as follows:

Patrimony of the absorbing company SC ALFA SRL

CURRENT NO.	ELEMENT NAME	BALANCE ON 31.12.2015
1	FIXED ASSETS	96708
2	CURRENT ASSETS	1453153
3	ADVANCE EXPENSES	428
4	TOTAL LIABILITIES	714678
5	NET ACCOUNTING ASSETS = ASSETS – LIABILITIES	835611
6	REGISTERED CAPITAL	200
7	CARRIED FORWARD PROFIT	795212
8	PROFIT OF THE FINANCIAL YEAR	40199
9	OWN EQUITIES	835611

Table 1. *Patrimony of the absorbing company SC ALFA SRL*

Patrimony of the absorbed company SC BETA SRL :

CURRENT NO.	ELEMENT NAME	BALANCE ON 31.12.2015
1	FIXED ASSETS	271739
2	CURRENT ASSETS	557961
3	ADVANCE EXPENSES	487
4	TOTAL LIABILITIES	783989
5	NET ACCOUNTING ASSETS = ASSETS – LIABILITIES	46198
6	REGISTERED CAPITAL	200
7	CARRIED FORWARD PROFIT	33081
8	PROFIT OF THE FINANCIAL YEAR	12917
9	OWN EQUITIES	46198

Table 2. *Patrimony of the absorbed company SC BETA SRL*

- The net accounting assets of the two companies upon the reference date is as follows:

TOTAL ASSETS	1550289
TOTAL LIABILITIES	714678
OWN EQUITIES (ASSETS MINUS LIABILITIES)	835611

Table 3. *Absorbing company SC ALFA SRL*

TOTAL ASSETS	830187
TOTAL LIABILITIES	783989
OWN EQUITIES (ASSETS MINUS LIABILITIES)	46198

Table 4. *Absorbed company SC BETA SRL*

- The exchange ratio in terms of the social parts has been calculated based upon the net contribution established for each of the two companies, following the evaluation of assets and liabilities, in compliance with the legal provisions in force.
- The calculation of the fair value for one single social part has been carried out as a ratio between the net contributions of the two companies taking part in the merger, and the number of social parts issued by the latter, as follows:

ELEMENT	Absorbing company SC Alfa SRL	Absorbed company SC Beta SRL
NET CONTRIBUTION	835511	46198
NUMBER OF SOCIAL PARTS	20	20
FAIR VALUE OF ONE SOCIAL PART (LEI)	41780	2310

Table 5. *The calculation of the fair value for one single social part*

- The determination of the exchange ratio in the case of social parts, in order to cover for the absorbed company's contribution.
- Given the fact that the absorbing company Alfa is to take over all the obligations of the absorbed company Beta, the exchange ratio of social parts, as determined for the purpose of the merger is as follows:

$$\text{Social parts exchange ratio} = \frac{2310}{41780} = 0.05 = \frac{5}{100} = \frac{1}{20}$$

Thus, the exchange ratio of social parts is of 0.05 social parts of SC Alfa SRL as newly issued, for one social part of SC Beta SRL , or in other words, one social part of SC Alfa SRL for 20 social parts of SC Beta SRL.

The number of social parts to be issued by the absorbing company Alfa following such a merger, as well as the way in which the latter are to be allotted are:

✓ Upon accomplishing the merger, all the social parts of the absorbed company Beta, existing prior to the merger, shall be annulled. In exchange of the social parts, the associates of the absorbed company SC Beta SRL shall acquire a number of social parts within the absorbing company, namely SC Alfa SRL, with the nominal value of 10 lei; moreover, the social parts shall be issued according to the resulting quantum, in full accordance with the above calculated exchange ratio, as well as subject to the legal provisions in force.

✓ Given the fact that the exchange ratio of the social parts, as established above, is 0.05, a number of 1.1. social parts was determined, with a nominal value of 10 lei, which shall be issued by the absorbing company SC Alfa SRL, in order to remunerate the net merger contribution of the absorbed company SC Beta SRL . The number of 1 (one) social part to be assigned to the associates of the absorbed company SC Beta SRL by the absorbing company SC Alfa SRL , upon the merger and the latter's integration within the structure of associates of the absorbing company SC Alfa SRL , has been determined in two distinct ways, both being stipulated by the norms, as follows:

$$\begin{array}{l} \text{Number of} \\ \text{social parts to} \\ \text{be issued by} \\ \text{the absorbing} \\ \text{company SC} \\ \text{Alfa SRL} \end{array} = \frac{\text{Net assets of the absorbed} \\ \text{company SC Beta SRL}}{\text{Fair value of one social part of the} \\ \text{absorbing company SC Alfa SRL}} = \frac{6498 \text{ lei}}{41780 \text{ lei}} = 1.10 \text{ social parts}$$

or :

$$\begin{array}{l} \text{Number of social parts to be issued by the Absorbing company SC Alfa SRL} = \\ \text{Number of social parts of the absorbed company SC Beta SRL} * \text{Exchange} \\ \text{ratio} = 20 * 0.05 = 1 \text{ social part} \end{array}$$

According to the Decision of the General Meeting of the Shareholders of the absorbing company SC Alfa SRL, since it is about one single social part, one shall waive the issuance of this single social part, and the distribution of the registered capital of SC Alfa SRL following such merger shall be carried out in compliance with the agreement between the associates of the two companies, which shall be stipulated in an associates' decision.

- 1) The merger premium in such a case shall be represented by the full net contribution of the absorbed company SC Beta SRL, namely the amount of 46198 lei.
- 2) Other matters regarding the post – merger balance sheet which shall be drawn up by the consolidation of the balance sheets of the absorbing company SC Alfa SRL and, respectively, of the absorbed company, namely SC Beta SRL .

2. The display in bookkeeping of the merger through absorption

The transfer of assets and liabilities from an accounting perspective shall be carried out upon consideration of the accounting rules in force. One shall draw up the synthetic balance which shall lay the foundation of the wind – up balance sheet, which shall be submitted to the competent tax body, prior to the drawing up of the erasure – related formalities.

The accounting monographic work corresponding to the absorbed company shall be hereby described below:

1. Transfer of own equities:

%	= 456	Settlements with the associates regarding the capital	46198
Paid up subscribed capital	1012		200
Carried forward result	117		33081
Profit or loss	121		12917

2. The taking out of management of the transferred assets :

Closing balance	892 = %	830187
Category 2 – Fixed assets accounts		271739
Category 3 – Accounts for stocks and production, in progress.		71043
Category 4 – Third parties account (receivables)		475249
Category 5 – Treasury accounts		12156

3. Transfer of liabilities :

%	= 892	Closing balance	830187
Category 4 – Third party accounts (debts)			783989
456 Settlements with the associates regarding the capital			46198

The entries in the bookkeeping of the absorbing company Alfa, following the merger through absorption are as follows:

1. The registration of the merger premium which shall be represented by the full net contribution of the absorbed company Beta:

Settlements with the associates regarding the capital 456 = 1042 Merger premiums	46198
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2. The taking over of the assets from the absorbed company Beta :

% = 891 Opening balance	830187
Category 2 – Fixed assets accounts	271739
Category 3 – Accounts of stocks and production in progress	71043
Category 4 – Third party accounts (receivables)	475249
Category 5 – Treasury account	12156

3. The registration of the receipt of liabilities:

891 Opening balance = %	830187
Category 4 –Third party accounts (debts)	783989
456 Settlements with the associates regarding the capital	46198

Through the effect of such merger, the absorbing or beneficiary company shall acquire the rights and obligations of the absorbed company, in terms of the latter's relation with third parties. Subsequent to the merger operation, the absorbing company shall draw up the balance sheet resulting from such a merger.

3. Tax considerations in terms of the merger through absorption

The tax implications of merger operations are stipulated by the Tax Code, as approved by virtue of Law no. 571 / 2003, with the latter's subsequent amendments and adjustments. The latter may be generally summarized as follows:

- Prior to the erasure from the Trade Register, for the purpose of establishing the fiscal result which is to be taken over by the absorbing company, one shall fill in and submit to the competent tax body the Statement having the code 101 regarding the tax on profit, in view of paying the same. At the same time, one shall also submit the VAT Settlement Statement code 300, so as for one to determine the VAT amount to be paid or to be reimbursed, as the same shall be taken over by the absorbing company.

- The absorbed company shall communicate to the absorbing company the tax value of each and every single element of assets and liabilities to be transferred.
- In the event when the absorbing company shall be a taxable entity registered for VAT purposes, the transfer of assets shall not be deemed as a delivery of assets, thence one shall collect no VAT whatsoever through the issuance of any invoice to this end.
- In terms of fixed assets that can be amortized, the absorbing company shall apply the same amortization regime as the absorbed company would have applied if such merger had not taken place.
- The absorbing company shall not recover the tax loss of the absorbed company if the said absorbed company has displayed tax losses upon the merger. Given these circumstances, in order not to lose the possibility of recovering such tax losses, a special attention should be paid when, at the level of a group of companies, one does not know for sure which direction the merger shall go to (which company shall be the absorbing company and which one shall be the absorbed).
- The absorbing company shall take over the tax values of the assets and liabilities, as the same were registered within the absorbed company, and if the same shall fail to be communicated, then their value shall be zero.

4. Conclusions

In view of eliminating any drawbacks which may occur following the implementation of a process of reorganization by means of a merger, as well as for the purpose of diminishing any related costs, companies should conduct a detailed analysis of all matters deriving from any such merger. An increased attention should be paid to the tax size of the process of reorganization through merger, which may bring huge savings to companies as well as help avoid the payment of any further taxes.

The tax and accounting elements held by the absorbing company prior to the merger, shall act in the same way as until the merger, with the mention that part of the assets and liabilities shall increase their value with the one received from the assets and liabilities of the absorbed company. Given the fact that both companies under analysis within the example above have the same main object of activity, namely the manufacturing of footwear, it requires the provision of a unitary strategy, which shall include the amalgamation of patrimonies, in view of the consolidation of the market position, the power of negotiation with the clients, as well as a unique management.

At the same time, the merger of the two companies shall have as a consequence the simplification of the accounting and tax reports required by the Romanian authorities and the achievement of time and cost savings. From an operational and logistic perspective, one such company's management shall become considerably easier and more efficient.

The said merger shall provide for continuity in terms of the profitable activity having been initiated and developed by the companies involved in this reorganization process and it shall contribute to a better allotment of resources at the absorbing company's level.

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