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Vetting compliance level with section 70F of the Taxation Act in mergers and acquisition of Malawian Banking Industry

By

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Abstract

Corporate restructuring is ubiquitous in view of external environmental factors (PESTLEE) and internal considerations (SWOT). Mergers and acquisitions are often some of the common tools used in corporate restructuring and these are governed by complex corporate reporting and taxation regimes. Malawi adopted International Financial Reporting Standards (IFRSs) through Malawi Companies Act 2013 and these recognise acquisition transactions while prohibiting merger accounting unless they fall under common control combinations. Acquisition in the Malawian banking industry is complicated by the fact that the acquiree must be merged with the acquirer so that it no longer exists. Meanwhile, the Malawian banks must also comply with Section 70F of the Taxation Act on the acquisition and merging process to be exempted from income tax otherwise the acquisition transaction is treated as a sale. The results of this study indicate serious shortfalls in compliance with the Reserve Bank of Malawi (2010) Guidelines for Processing Applications for Bank Mergers and Acquisitions in some of the acquisition transactions and therefore substantial income taxes could be levied on some material transactions. It is indeed important to evaluate any opportunity to increase government coffers arising out of violations of the taxation code.

Type of Paper: Practitioner’s View Point

Key words: Taxation; Mergers, Acquisition; Malawi

1.0 Introduction

Section 70F of Malawi Taxation Act is lengthy and is presented in appendix 1 of this paper but the gist of it is that the former owners of the acquiree are not subjected to income tax on the disposal of the control in the investee if the transaction qualifies as merger in which at least eighty per cent (80%) of shareholding is acquired by another entity. The income tax issue on the acquisition is particularly relevant in the Malawian banking industry in two fold:

1.1 Tax payable by former owners of acquiree

The selling price of shares would have to factor in the tax element as former owners of acquiree would have to factor the income tax element in the final price as payment would be subjected to withholding tax regime. The tax element would therefore distort the final acquisition price.

1.2 Reserve Bank of Malawi prior approval

The Reserve Bank of Malawi Mergers and Acquisition Guidelines (2010) requires that merger should take place when one bank acquires another. Consequently, in the merging process, the party absorbing the acquired bank might be subjected to pay income tax if the conditions of section 107 F are not met despite the transaction qualifying as common control combination since the merging companies are regarded as separate legal entities under Malawi Companies Act and Taxation Act.

2.0 Methodology

The study evaluated acquisitions and subsequent mergers in the Malawian banking industry between 2010 and 2021. This involved holding companies too which are subjected to the Reserve Bank of Malawi supervision under the Financial Services Act (Financial Holdings Directive) 2018. Document analysis in the form of local banks' annual reports, Reserve Bank of Malawi Annual Reports, Malawian banks' abridged financial statements and other relevant documents. The process looked at disclosures made in such documents regarding taxation on acquisition transactions so as to critically determine the compliance level and make recommendations on redressing any exceptions.

3.0 Results

Eight banking acquisitions and mergers took place between 2010 and 2020 A thorough analysis of each transaction is presented below:

3.1 Acquisition 1

This involved acquisition of 100% shareholding in the acquiree. The notes in the group financial statements stipulated the merging operations of the acquired bank and the acquirer and not merging of the entities. This was not in line with the Reserve Bank of Malawi Mergers and Acquisitions Guidelines (2010) since the acquired bank should cease to exist as it must be swallowed by the acquirer. The carrying amount of the acquired bank substantially dropped in the subsequent year after the acquisition and was reported under segment reporting.

The acquiree is currently depicted as a dormant company in the books of the acquirer but this was not supposed to be the case as it should have ceased to exist and deregistered. This was further contravention of Reserve Bank of Malawi Mergers and Acquisitions Guidelines (2010).

There was no disclosure regarding compliance with Section 70F of the Taxation Act. This therefore means that income tax was supposed to be assessed on the merging of the operations of acquirer and acquiree and payable by acquirer.

3.2 Acquisition 2

Initially, 75% shareholding was acquired in one bank by a shareholder (holding company) of another bank. An additional 5% was subsequently acquired after the acquisition contracts were already drawn, signed and delivered. Nevertheless, the shareholding increased to 80% which qualified the acquisition to fall under section 70F of the Taxation Act although this was not publicly disclosed in the financial statements.

The subsequent financial statements of the merged bank included a capital reserve being a transfer of share capital and share premium of the absorbed bank and the presumed acquirer. There were no further disclosures as to why several reserves such as Retained Earnings, Revaluation Reserves and Loan Loss Reserves were ignored in the process of amalgamation of two banks in the nature of mergers.

The goodwill which was recognised on the acquisition of the bank by the common shareholder was subsequently written off well after the merger had taken place and that was an exception as goodwill was supposed to be eliminated concurrently with the merger.

3.3 Acquisition 3

The merger of the two banks was approved as a Qualified Reorganisation under Section 70F of the Taxation Act by the Malawi Revenue Authority. As a result, the two banks are considered as one for taxation purposes.

This approved reorganisation was effectively a combination of the two banks. The accounting standard that deals with this type of transaction is IFRS 3 Business Combinations. However, IFRS 3 does not apply to a combination of entities or businesses under common control.

The excerpt of the Key Audit Matter stated:

[The treatment includes:

• Transferring of the assets and liabilities of (acquiree) into the statement of financial position of (acquirer) at their book values;
• All reserves including retained earnings and share capital of (acquiree) were retained in (acquiree) pending a formal liquidation process. (Acquirer) has not yet decided to transfer the reserves to (acquirer) because the future of (acquiree) (now a dormant company) is yet to be decided on. Also retained in (acquiree) books were the investments in its two subsidiaries, Investee 1 and Investee 2;].

There were possible violations of the provisions of the Malawi Companies Act 2013. Section 354 (1) of the Malawi Companies Act 2013 stipulates that a company shall be dormant for any period during which no significant accounting transaction occurs in relation to the company and shall cease to be a dormant company when any significant transaction occurs in relation to the company. Section 354 (2) of the Malawi Companies Act 2013 excludes issuance of shares and other unavoidable expenses such as payment of bank charges, licence fees and any other compliance fees. Acquiree was merged with acquirer when it still had investees 1 and 2 which were trading and therefore eligible to dividend. Furthermore, dormancy occurs from the last accounting period as outlined by section 355(1)(b) of the Companies Act while the merging process occurred midway the year and could not be related to the last accounting period as it continued to trade subsequent to the last accounting period. Section 355(2) of Malawi Companies Act 2013 states that a company shall not declare itself to be a dormant company where it is formed for the business of banking or insurance. Much as the acquirer classified the acquiree as a dormant company because the acquiree had surrendered its banking licence to the Registrar of Financial Services (Reserve Bank of Malawi), it is not the acquirer which can declare its acquiree as dormant but the acquiree itself doing so after satisfying Section 354 of the Malawi Companies Act. The merged acquiree in this case had two significant investee 1 and 2 and therefore compelled to produce group accounts which were significant transactions and therefore not a dormant company.

Going by the above analysis, it can be concluded that the tenets of section 70F of the Malawi Taxation Act were not complied with.

3.4 Acquisition 4

The notes of the acquirer stipulated as follows:

[On the same acquisition date, (acquiree) merged with (acquirer). This was through a Scheme of Arrangement approved by the Reserve Bank of Malawi (RBM). The merger of the two entities was also approved as a Qualified Reorganisation under Section 70F of the Taxation Act by the Malawi Revenue Authority.

(acquiree's) assets acquired and liabilities assumed were transferred into the statement of financial position of (acquirer) at the same fair values determined as part of the acquisition date accounting. For taxation purposes, (acquiree's) assets have been transferred across at their tax written down values as at the date of the merger. This treatment complies with the requirements of Section 70F of the Taxation Act on Qualified Reorganizations.].

Acquisition and merging of the financial statements cannot take place on the same date. What was perhaps meant in the above quote was the combination of the banking processes. This can be vindicated by a further disclosure in the acquirer's financial statements that consolidation of the acquiree was based on the provisional figures and subjected to possible adjustments. The announcement of the acquisition was made about seven months into the financial year while the regulatory approvals by the Registrar of Financial Institutions was granted three months later with final approval from the Competition and Fair Trading Commission (CFTC) in the subsequent year. The merger could only take place after CFTC's approval. This does not appear to be the case in this regard. Furthermore, there were no disclosures regarding the treatment of the reserves of the acquiree during the merging of the financial statements process. The risk of material misstatement of the financial statements in this regard was quite high.

3.5 Acquisition 5

This was reorganization of the group through insertion of the shell company at the apex of the group. The assets of the original parent company were subsequently transferred to the new company registered as a foreign company in Malawi. There were no disclosures regarding compliance with Section 70F of the Malawi Taxation Act. Further analysis of this transaction could be required in this regard considering the sheer volume of the monetary value of the transaction.

3.6 Acquisition 6

The notes of the acquirer stipulated as follows:

[On ..., (parent company) merged with (wholly owned subsidiary). This was through a Scheme of Arrangement approved by the Reserve Bank of Malawi (RBM). The merger of the two entities was approved as a Qualified Reorganisation under Section 70F of the Taxation Act by the Malawi Revenue Authority.].

The comparison of the financial results between half yearly results as at 30th June and the date of merging which was almost six months thereafter revealed the following:

3.6.1 Material differences in carrying amount

There were material differences in the carrying amount of property and equipment between the prior accounting period and the date of the merger since the depreciation charged during the period up to the point of the merger was much lower. The substantial loss thereof ought to be pursued further as it had an impact on the tax assessment.

3.6.2 Substantial amount of share premium

Share premium was part of the net assets transferred during the merger. It represented well over 10 per cent of the net assets transferred. The share premium arose from a single shareholder's transactions and this appears to be irregular more or so as the separate financial statements of the acquirer indicated that its total investment written off as a result of the merger was about one-sixth of the share premium.

3.7 Acquisition 7

The financial statements of the acquirer did not incorporate the acquisition transaction involving the acquiree. Consequently, the group accounts did not indicate whether goodwill arose on the acquisition of the other bank although the bank acquired qualified as a business and not mere asset and was therefore supposed to be accounted for under business combination in line with IFRS 3.

The two banks subsequently merged their operations as per the requirement of the Reserve Bank of Malawi Mergers and Acquisitions Guidelines (2010) since the other bank surrendered its banking licence. There is however no proof that merging accounting was adopted. There were no disclosures of compliance with section 70F of the Malawi Taxation Act.

3.8 Acquisition 8

Like with Acquisition 7 above, the financial statements of the acquirer did not incorporate the acquisition transaction involving the acquiree. Consequently, the group accounts did not indicate whether goodwill arose on the acquisition of the other bank although the bank acquired qualified as a business and not mere asset and was therefore supposed to be accounted for under business combination in line with IFRS 3.

The two banks subsequently merged their operations as per the requirement of the Reserve Bank of Malawi Mergers and Acquisitions Guidelines (2010) since the other bank surrendered its banking licence. There is however no proof that merging accounting was adopted. There were no disclosures of compliance with section 70F of the Malawi Taxation Act.

4.0 Conclusion and recommendations

The results of this study indicate total confusion in the merging processes of Malawian banks which must be done upon acquisition of one bank by another. The Reserve Bank of Malawi Guidelines on Mergers and Acquisitions (2010) does not provide specific directives regarding accounting policies and transactions to be adopted by merging entities considering the fact merger accounting is not permitted under International Financial Reporting Standards which Malawi adopted through its incorporation in the Malawi Companies Act 2013. What can be allowed though is business combination under common control which must borrow principles from the United Kingdom GAAP under Financial Reporting Standard 6. These are technical matters which must have prescribed accounting guidelines to eliminate varying significant judgements from merging parties which have different levels of understanding and motives. The merging of two Malawian banks must meet the conditions of section 70F of the Malawi Taxation Act in which at least eight percent shareholding must be held by acquirer in acquiree if the merging process has to be exempted from taxation. This important element is not highlighted in the Reserve Bank of Malawi Guidelines on Mergers and Acquisitions (2010). Furthermore, it should be clearly demonstrated that the ultimate authority in the mergers and acquisitions in the Malawian bankingindustry is the Competition and Fair Trading Commission (CFTC).

This study proposes the following recommendations:

a) Reserve Bank of Malawi should urgently revise its guidelines on mergers and acquisitions in Malawian banking industry to incorporate the International Financial Reporting Standards embedded in the Malawian Companies Act 2013 so that merger accounting should be properly described and provide examples on how merging banks in Malawi would carry out the accounting transactions to minimise risk of material errors to the detriment of the users of the financial statements.

b) Reserve Bank of Malawi guidelines on mergers and acquisitions should clearly stipulate the role of Malawi Revenue Authority in approving the transactions under section 70F of Malawi Taxation Act and this should be made known to the intended merging parties well beforehand.

c) Reserve Bank of Malawi should clearly demonstrate that the final authority regarding mergers and acquisitions in the banking industry rests with Competition and Fair Trading Commission including COMESA Competition Commission (where a regional bank is involved). This will be helpful to the interested parties to understand the time-frame under which the transaction can be concluded.

d) Malawi Revenue Authority to assess any tax payable by merged banks which did not adhere to the obsolete Reserve Bank of Malawi Guidelines on Mergers and Acquisitions (2010) as noted in Acquisition 1 as well as Acquisitions 7 and 8 above.

e) Institute of Chartered Accountants in Malawi (ICAM) should provide merger accounting guidelines to comply with section 70F of Malawi Taxation Act.

Appendix 1: Section 70F of Malawi Taxation Act

70F. Basis of assets in a qualified reorganization of a company

(1) In the case of a qualified reorganization of a company, as defined in subsections (5) and (6), the basis of an asset so acquired shall be determined by reference to the adjusted basis of the asset immediately before the reorganization.

(2) Acquiring company assumes tax attributes of the acquired entity except as otherwise provided in this Act, the acquiring company shall take into account the tax attributes of the acquired entity.

(3) Distributions as part of a qualified reorganization - Distributions of equity shares in a company which is a party to a qualified reorganization to any shareholder of any company which also is a party to the same qualified reorganization shall not be taxable to the receiving shareholder, but any other distributions of cash or other property shall be taxed to the recipient as consideration received in a sale or exchange.

(4) Non-qualified reorganization to be treated as a sale of the company - Any reorganization which is not a qualified reorganization shall be treated as a sale of the company and of all of its assets.

(5) A "qualified reorganization" to have a written plan and to be for valid business purposes and not for tax avoidance - For the purposes of this Act, "qualified reorganization" means a reorganization pursuant to a written plan undertaken for valid business purposes and which does not have as its purpose tax avoidance by any person who is a party to the reorganization, and in determining whether a transaction is a qualified reorganization, the Commissioner shall disregard the form of the transaction where the form is inconsistent with the substance of the transaction.

(6) Meaning of "reorganization"For the purposes of this Act, "reorganization" means— (a) a mere change in a company's form; (b) a recapitalization of a company; (c) a combination of two or more companies into a single company; (d) a division of a company into two or more companies; (e) the acquisition of at least eighty per cent of the equity interests in a company in exchange solely for equity interests in the acquiring company; and (f) the acquisition of at least eighty per cent, by value, of the assets of a company in exchange solely for equity interests in the acquiring company. [10 of 1993]