Chapter 24
The Effect of the Deferred Tax on Business Combinations in the Czech Republic

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Abstract This chapter is a starting point of a research project which aims to analyze and evaluate various approaches to financial reporting of deferred tax during business combinations currently used in the Czech Republic. Since the current Czech national regulation offers only limited guidance on deferred tax reporting, practitioners apply diverse approaches which lead to the decreased comparability of the financial statements and might lead the users of the financial statements to misinterpretation of the data presented. This chapter describes the concept of the research work – the data gathering, analytic procedures, and some of the intended evaluation methods. The aim of this research is to describe the current practice using the descriptive analysis of the whole population of business combinations like legal mergers, spin-offs, etc. which occurred in the Czech Republic in the period of 2015–2019.

Key words Deferred tax · Business combinations · Equity

24.1 Introduction

Deferred tax is often considered a difficult topic of financial reporting – especially for practitioners who often face numerous challenges in their attempts to identify all the temporary differences which might give rise to a deferred tax asset or to a deferred tax liability. Unfortunately, this issue brings a whole new level of complexity when set in the context of business combination. The regulation of financial reporting in the Czech Republic is carried out mostly through the Accounting Act no. 563/1991 Sb. and decrees of the Ministry of Finance which are closely tied to the tax and business law (Pospíšil & Strojek-Filus, 2017). Such regulation provides rather rigid rules for financial reporting which often does not allow entities to report business combinations in a way that would best depict their nature. Moreover, the

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current Czech national regulation offers only limited guidance on deferred tax reporting. As a result, practitioners apply diverse approaches which lead to the decreased comparability of the financial statements and might lead the users of the financial statements to misinterpretation of the data presented.

This chapter is a starting point of a research project which aims to analyze and evaluate various approaches to financial reporting of deferred tax during business combinations currently used in the Czech Republic. The research team is going to gather the data of business combinations which were carried out according to the Act no. 125/2008 Sb. on company transformations during the 5 years period and evaluate:

- How do the entities report their deferred tax?
- How does the deferred tax influences goodwill recognized as a result of the business combination?
- Whether the deferred tax recognition impacts equity.

This chapter describes the concept of this research. The main purpose of this research project is to contribute to the harmonization of reporting methods when dealing with the deferred tax during the business combinations, which shall lead to increased understandability and comparability of the financial statements of Czech entities, and also to assist in reaching just taxation in some cases since some of the aspects a transformation project deals with have direct impact on corporate income tax of Czech entities as well.

24.2 Data and Methodology

Deferred tax is reported either as a deferred tax liability or a deferred tax asset. According to IAS 21, the deferred tax liability is an amount of income taxes payable in future periods in respect of taxable temporary differences, while the deferred tax asset is the amount of income taxes recoverable in future periods in respect of deductible temporary differences and tax losses and tax credits deductible in the future periods. The focal point of our research is the temporary differences which arise during the business combinations. According to IAS 21, temporary differences are differences between the carrying amount of an asset or liability and its tax base. Business combinations (as defined below) give rise to new temporary differences, usually due to the revaluation of asset during the purchase price allocation process.

The object of this research is deferred tax measurement and recognition during business combinations which occurred in the Czech Republic in the 5-year period from 2015 to 2019. For the purpose of our research, we define business combinations as those transactions with corporations and their net assets that meet the definitions of the Act no. 89/2012 Sb. and Act no. 125/2008 Sb. of the Czech Republic which outlines general types of company transformations available for companies in the Czech Republic. It is important to note that our definition of the term “business combination” does not comply with general understanding of this term, which is defined by International Financial Reporting Standards (specifically: IFRS 3 Business Combinations). While the definition of the term "business combination" set by IFRS 3 comprises of transactions in which an acquirer obtains control of one or more businesses and includes transactions like share deals or asset deals (acquisition of business), our definition of this term does not include these transactions. Act no. 125/2008 Sb. deals mostly with legal merges ("fúze") and separations ("rozdělení"). These are formal legal procedures which do not distinguish between real acquisition and mere reorganizations.

For the purposes of this research, we adopt merger classification as described by Pospíšil and Vomáčková:

> True merger (in Czech: "fúze splynutím") is defined as a transaction in which at least two companies cease to exist, and their net assets are transferred to at least one new company which emerges from the transaction as their successor. Acquisition merger (in Czech: "fúze sloučením") is defined as a transaction in which one or more companies cease to exist and their net assets are transferred to another existing company which absorbs the net assets transferred and continues its existence. (Pospíšil & Vomáčková, 2017, 1908)

For the purposes of this research, we adopt separations classification as described by Pospíšil and Vomáčková:

> Spin-off (in Czech: "odštěpení") is defined as a transaction where an existing company detach a part of its business which forms a new company while the original company continues its existence. Merger spin-off (in Czech: "odštěpení sloučením") is defined as a transaction in which an existing company detach a part of its business and transfer the respective net assets to another existing company which incorporates the net assets into its own structures, while the original company continues its existence. Split (in Czech: "rozštěpení") is defined as a transaction in which a company ceases to exist, and its nets assets are used to form at least two new companies. Merger split (in Czech: "rozštěpení sloučením") is defined as a transaction in which a company ceases to exist, and its net assets are transferred to at least two other existing companies which incorporate the net assets into their own structures. (Pospíšil & Vomáčková 2017, 1908)

Another important difference between our definition of the term "business combination" and the definition included in IFRS 3 is the fact that we do not exclude transactions with businesses or corporations taking place between (among) parties under common control. Moreover, while IFRS 3 requires that business combination must be a transaction with a business, Act no. 125/2008 Sb. does not require that the characteristics of business are met – the same accounting method applies to any transaction with a corporation and its net assets as long as it is legally structured and carried out in accordance with the Act no. 125/2008 Sb.

To gather the data necessary for the analysis and evaluation, we are data-mining two major databases administrated by the Czech government, namely, the Corporate Register which is administrated by the Czech Ministry of Justice and the Business Bulletin which is administrated by the Czech Ministry Interior. According to the Act no. 125/2008 Sb., all corporations undergoing the transformation process are required to publicly announce this transaction in the Business Bulletin and to publish the relevant documentation (the financial statements and the transformation project) in the Corporate Register.

The number of transformations which occur every year amount to approximately 900. We are going to analyze the whole population.

The data extraction is mostly manual. Except for the financial statements, the source documents are not well structured. Nevertheless, we are taking advantage of some external databases like Amadeus, Albertina, or MagnusWeb to gain basic descriptive data about the corporations undergoing the transformation. These data include net assets, equity, debt, revenue, industry sector, and information about auditor.

The first component of our analysis is the measurement of the deferred tax. We are looking to verify whether the successor company reported an increase or a decrease in the deferred tax asset or the deferred tax liability. Then we cluster the transactions which resulted in the goodwill recognition (referred to as "GW cluster") and the transactions which resulted in OCER recognition (referred to as "OCER cluster"). OCER (i.e., "Oceňovací rozdíl k nabytému majetku") is a Czech specific item similar to goodwill which consists of goodwill and a revaluation surplus which should be otherwise allocated to the net assets as part of the purchase-price allocation process. On each cluster, a series of calculations is performed in order to verify the amount of goodwill, OCER, and deferred tax recognized.

There are several methods for deferred tax measurement during the business combinations in the Czech practice. The additional deferred tax is sometimes calculated as a product of the corporate income tax rate and the OCER or goodwill (Skálová, 2019). This approach leads to the recognition of the deferred tax from temporary differences on goodwill which is prohibited, for example, by IAS 12 or NÚR I-1. Another approach, usually referred to as "gross-up method," assumes that the value of the net assets acquired is a "post-tax value" and needs to be adjusted (usually increased) by the deferred tax in order to obtain the gross value (Bajgerová, 2016). The difference between the "post-tax value" and the grossed-up value is then recognized as the deferred tax and an increase (in the case of deferred tax liability) or decrease (in the case of the deferred tax asset) of goodwill or OCER. Lastly, there is another method applicable for goodwill only, where the amount of the deferred tax equals to the product of the corporate tax rate and the difference of the net asset value and the goodwill (Pelák, 2016). In our research, we are going to verify the calculation of the deferred tax in the opening balance sheet of the entities participating in the business combination by:

- Comparing the total value of deferred tax recognized in the financial statements of the participating entities to the deferred tax recognized in the opening balance sheet of the successor entity.
- Comparing the equity increase in the successor's opening balance sheet to the net assets value of the participating companies.

Revaluation of net assets during the business combination usually results in an increase of the deferred tax liability. Current regulation is not clear as to which item should absorb the change in the deferred tax. In the case of the acquisition method, as described in the IFRS 3, the deferred tax is considered part of the net assets acquired and as such is included in the goodwill calculation. Czech accounting regulation (specifically Decree no. 500/2002 Sb.) stipulates a different approach where the change in the deferred tax is either recognized as a gain/loss in the income statement or recognized as part of the balance sheet item. Other retained earnings ("Jiný výsledek hospodaření minulých let") which is a special component of retained earnings designated for restatements of accounting errors and impacts of changes in accounting policies. Some authors point out that this treatment is not appropriate for business combinations and argue that the change in the deferred tax should be recognized as an increase or decrease of equity, more specifically at the account group 41 which represents registered capital, contributions, and other paid-in capital (Pospíšil, 2020). In our research, we examine how entities report these changes in the deferred tax in their business combinations by:

- Comparing the total value of other retained earnings recognized in the financial statements of the participating entities to the other retained earnings recognized in the opening balance sheet of the successor entity.
- Testing whether the increase (or decrease) in the total deferred tax recognized equals to the product of tax rate and OCER (or goodwill).

Some of the business combinations require valuation (fair value) of the net assets acquired by court-appointed valuation expert. This valuation serves as a proxy for market price of the business (corporation) as a whole. The accounting treatment prescribed by the Czech regulation of financial reporting introduces a fiction of law that such business combination is in fact an exchange (an acquisition) because the essence of the prescribed accounting procedures is in fact a purchase method for business combinations. Therefore a "fair value" of net asset is necessary in order to calculate goodwill or OCER according to one of the following formulae:

$$GW = V - \left(\sum A_{FV} - \sum L_{BV}\right) \tag{24.1}$$

$$\mathrm{OCER} = V - \left(\sum A_{BV} - \sum L_{BV}\right) \tag{24.2}$$

where GW stands for goodwill; OCER stands for "Oceňovací rozdíl k nabytému majetku"; V is net assets valuation (business/corporation as a whole); A means assets acquired; L means liabilities assumed; FV stands for fair value; and BV stands for book value.

The calculation of goodwill or OCER might be influenced by the deferred tax asset or a deferred tax liability. According to IFRS 3, the deferred tax should be included in the value of the net assets which in the Eqs. 24.1 and 24.2 is represented by the expression in brackets (Maruszewska et al., 2019). Czech regulation chose different approach, where the deferred tax is recognized through other retained earnings, independently on goodwill or OCER calculation. Still there is an anecdotal evidence that some entities opt for IFRS approach instead of the approach prescribed by the Czech national regulation of financial reporting. In our research, we will examine whether the calculation of goodwill or OCER was influenced by the deferred tax through goodwill or OCER calculation simulation on data gathered from the financial statements of the entities participating in the transaction.

The calculation of the change of deferred tax as a result of a business combination is usually a difficult task due to the fact that it is often unclear how the net asset valuation (the “*V*” variable in the equations above) was determined. Valuation experts employ various valuation models, for example, DCF method, multipliers derived from the market stock prices, yield methods, or cost methods. While some of these methods are in fact able to take into account the temporary differences which give rise to deferred tax, other methods are not. Unfortunately, many valuation experts in the Czech Republic are not well acquainted with the deferred tax concept and thus pay little regard to this phenomenon (Jindra, 2012). For financial reporting professionals, it is then very difficult to understand whether the value of the net assets (business/corporation as a whole) provided by the valuation expert is a post-tax value or pre-tax value and whether the respective tax effects in the valuation model acknowledges the fact that the successor entity in the business combination is required by Czech tax law to adopt tax values of all assets acquired and liabilities assumed (Pelák, 2010). In our research, we examine whether the valuation experts address the issue of the deferred tax in their valuation reports explicitly and how do they include the deferred tax in their valuation models. Especially in the case of the cost valuation methods, we will analyze whether the resulting valuation was adjusted for the deferred tax liability or deferred tax asset. We expect to encounter three most common scenarios:

1. The valuation is not adjusted for the deferred tax at all.
2. The valuation is adjusted only for the deferred tax reported by the entity in its financial statements prior to the business combination.
3. The valuation is adjusted for the deferred tax which is calculated by the valuation expert based on the resulting valuation of the net assets.

For scenario 2, we check for the situations where there was no deferred tax recognized in the entity’s financial statements prior to the business combination. There is an exception in the Czech accounting regulation for small entities which are not required to recognize deferred tax in their financial statements. Moreover, some entities might not report their deferred tax asset due to the prudence principle.

Our research pays special attention to the mergers following share deals in which the acquirer purchased 100% share in the target. Large portion of mergers takes place shortly after the share deal to finalize the acquisition process (Pospíšil & Vomáčková, 2018). Rather distinctive group of these “follow-up mergers” is represented by property transactions in the real estate sector. Until 2020, all property purchase transactions were subject to special property-transfer tax. To avoid this taxation, some corporations structured their property acquisitions through the business combinations. The seller first spin off the property to a special purpose entity which was then sold to the acquirer who carried out a merger shortly after in which the special purpose entity ceased to exist and its net assets (i.e., the property) transferred to the acquirer. These transactions are in fact the acquisition transaction even though they are carried out as a spin-off followed by a share deal and merger. Nevertheless, these transactions still do not meet the definition of business combination according to IFRS 3 as the goal here is to purchase a property rather than business. On the other hand, the calculation of the temporary differences and the deferred tax should be rather straightforward compared to the transactions with businesses.

The literature review shows that there is a controversy regarding the option to use the business combination to achieve fair value valuation of assets, especially in situations where the transactions take place between the parent entity and its subsidiary or related parties in general. Some claim that such accounting treatment should be allowed only for business combinations between (among) non-related parties, where true acquisition happens. Enabling this method for transaction under common control makes possible to recognize an unrealized gain in equity of the acquirer as a result of a mere reorganization (Vomáčková, 2013). Others claim that in the case of the follow-up mergers, the valuation of assets acquired at their fair value is legitimate as the follow-up merger simply completes the acquisition which in fact occurred at the preceding share deal.

Apart from the quantification of portion of all the transactions that can be considered as follow-up mergers, we examine whether the merger was structured in a way that allowed valuation of net assets at their fair value. Then we use this data to assess how frequent the revaluation of net asset helped the successor company to overcome the threshold set by Act no. 586/1992 Sb. for tax deductibility of loan interests. This rule limits the amount of tax-deductible interest from loans provided by a related party to the maximum of interest calculated from principal four times higher than the debtor's equity (Lukeš, 2020a, b).

Together with the aspect of the tax deductibility of the interest on the intra-group loan, we analyze how many entities taking part in the business combination took advantage of the option to extend their accounting period. By the means of extending accounting period (up to 24 months), entities also extend the period for tax returns and thus defer the actual tax payment day. This option might be misused by overlaying/linking more business combinations in a row (Lukeš, 2020a, b). In our research, we measure the length of the accounting period which corresponds to the periods for tax returns to find out whether some companies exploited this option.

In some cases, the revaluation of net assets might be necessary to finalize the business combination. This is often the case of mergers between parent and its subsidiary in which case the amount of the investment disclosed in the financial statements of the parent must be eliminated against the value of subsidiary's equity, fair value of subsidiary's net assets, respectively (Mikyska & Skálová, 2019). We identify all business combinations in the specified period of 2015–2019 which would not be possible without revaluation of the net assets which were transferred to the successor company. Then, we confront this information with our findings regarding the follow-up mergers, where revaluation might have economic substance and might increase the informative potential of the financial statements as opposed to business combinations under common control which are not considered follow-up mergers, where employing the revaluation option lacks economic substance, because in such cases there are no real acquisitions.

From our previous research work, we have gathered evidence that the accounting treatment used in some business combinations between parent and subsidiary does not comply with certain provisions of Act no. 125/2008 Sb. which require valuation experts to adjust their valuation by the value of the investment recognized in the financial statements of the parent entity. In our research, we also examine the frequency of cases where the valuation expert omits this adjustment.

Specifically, for spin-offs (from subsidiary to parent), we do have anecdotal evidence that in some cases the parent does not adjust the value of their investment in a subsidiary even though they have performed the spin-off through which a portion of the subsidiary's equity was transferred to the parent. In our research, we are going to verify this anecdotal evidence and quantify the share of transactions where such misstatement occurred.

24.3 Conclusion

This chapter discussed the current unclear practice of financial reporting for the effects of additional temporary differences arising during the business combinations like legal mergers and spin-offs in the Czech Republic. It has described the data gathering and research process for the research project in progress which aims to describe the current practice of deferred tax reporting in the context of business combinations using the descriptive analysis of the whole population of business combinations which occurred in the Czech Republic in the time span of 5 years (from 2015 to 2019). Since the amount of the deferred tax arising on the additional temporary differences can be rather significant in some transactions, various accounting treatments which currently remain without proper harmonization may often lead to creative accounting, window dressing, misstatements, and potential distortions in goodwill or equity valuation and recognition in the successor's financial statements. Successively, such misstatement could potentially lead to retained earning overestimation thus create opportunities to wrongful dividend payouts or to contribute to stock market bubbles forming.

At this point, there are no particular conclusions to be drawn since the research itself is still in progress. However, even at such an early stage, we have found and described several cases of mergers and spin-offs which were reported in the financial statements in the wrong way, even though the respective financial statements were audited. In some instances, such erroneous reporting enabled finalizing mergers which were badly structured and should have never been successfully finalized. We have also identified cases where mergers between parties under common control led to recognizing unrealized gain in the balance sheet of the "acquirer" which were distributed to the owners shortly after the finalization of the merger using the debt financing. Last but not least, we have found many transactions which either disregarded the deferred tax completely or, on the other hand, used the recognition of the deferred tax in a wrong way, which allowed the company to meet the debt-to-equity ratio of interest deductibility for income tax purposes.

I do expect that this research project will contribute significantly to the harmonization of reporting methods when dealing with the deferred tax during the business combinations, which shall lead to increased understandability and comparability of the financial statements of Czech entities. Hopefully, it will also assist in reaching a just tax regime in some problematic cases where the amount of deferred tax is significant, and the incorrect reporting might allow for favorable (and in some instances unjustified) corporate income tax regime.

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