KPMG - TAXATION OF CORPORATE REORGANIZATIONS

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Corporate reorganizations have become an increasingly relevant topic in Kazakhstan in the last decade, leading to the question of how entities involved in reorganization transactions, as well as their shareholders, should be taxed.

Historically, Kazakhstan's tax laws have barely addressed corporate reorganizations and the tax implications these transactions invoke. The present tax law only discusses the procedural aspects of discharging a tax liability to the newly formed or surviving entities in a corporate reorganization. In addition, the tax law provides certain rules for some tax attributes, such as tax overpayments and input VAT and their transfer from one entity to another, but falls short of discussing the transfer of other tax attributes – such as net operating losses, for example.

It is expected that the existing set of tax rules related to corporate merger and division arrangements will be expanded further this year, although at the time of writing this article the corresponding legislation has yet to be voted on in the Senate. The new rules, expected to be enacted on January 1, 2019 (provided that the Senate votes to do so), are designed to clarify issues relating to newly formed or surviving entity assets in corporate reorganizations.

While both the above topics (i.e. the transfer of tax attributes and determination of the transferee's tax basis) are critical tax areas, the existing lax law unfortunately does not clarify whether corporate reorganizations in principle represent a realization event for income tax purposes. More specifically, Kazakhstan's tax law at present overlooks tax-free corporate reorganizations altogether and fails to provide guidance on treating these reorganizations differently from basic asset or share sale transactions.

The Concept of Tax-Free Corporate Reorganizations

From a tax perspective, the notion of a *corporate reorganization* encompasses the vast array of corporate rearrangements in which assets of one entity are transferred to another entity, as happens in corporate mergers and divisions. Moreover, corporate reorganizations may result in the transferor entity's assets being retained by this entity itself but controlled by new shareholders. Investments in kind and share-for share exchanges entail this result.

There are many reasons why businesses carry out corporate reorganizations. While some of these transactions truly represent, both in form and in substance, a sale of shares in or assets of a business, some corporate reorganizations resemble such a sale in form only, not in substance. This category of corporate reorganizations does not technically represent a realization event from a tax perspective; thus, an increasing number of jurisdictions worldwide design a specific set of tax rules that allow taxpayers to conduct tax-free corporate reorganizations.

There are different reasons why a corporate group of companies might wish to pursue a corporate reorganization that does not involve any realization of a gain but is conducted purely for internal reasons. For example, such rearrangements may expand into new businesses or service lines or abandon pre-existing businesses that are not sufficiently profitable. Sometimes businesses may even be forced into a corporate reorganization in order to meet changing regulatory requirements.

From a tax perspective, the main technical dilemma related to corporate reorganizations, such as mergers and divisions, is deciding how to treat the gains and losses resulting from share or asset transfers. In an ordinary asset or share sale transaction with a third party, such a transfer is treated as a realization event with the corresponding taxable gains or tax-deductible (creditable) losses being realized by the transferor. However, if the contemplated reorganization anticipates continuity of control by the transferor after the reorganization, it could technically be argued that, although the arrangement looks like a sale in appearance, it does not represent a genuine realization in substance.

The *continuity of control* test is a critical concept that serves to explain why treating a corporate reorganization that meets this test as a tax-free transaction is methodologically justified and represents a fair tax treatment. This concept requires that, in substance, a substantial part of the value being transferred in the reorganization is still preserved within the same corporate group and continues to be

controlled by it. This principle could be properly applied to any type of corporate reorganization, be it separation-type or consolidation-type mergers and divisions; and to transfers of any type of assets, be it shares, ownership interests, or other assets.

Although they are called *tax-free*, these rules are not designed to grant a tax exemption to any party to the corporate rearrangement. As long as it is accepted and agreed that a corporate reorganization triggers only a change in appearance, but never a change in substance, such rules aim to neutralize the tax effects of the reorganization so that it delivers neither a tax advantage nor a tax disadvantage to any taxpayer involved. These rules serve to allow taxpayers to combine or separate businesses and shift ownership interests within their corporate group without triggering the tax impact on an (as of yet) unrealized gain or loss.

Therefore, deferring taxation in a tax-free corporate reorganization until the resulting gains or losses are realized is never a tax exemption or a tax preference. By the same logic, the purpose of a tax deferral is never promoting or otherwise stimulating corporate reorganizations. The purpose is to effect reorganizations that yield unrealized gains tax-neutral only.

Conclusion

Kazakhstan's tax law has never stipulated any tax-free corporate reorganization rules and, to the best of our knowledge, no such rules should be expected to be introduced into the tax law within the next year or so, despite the business community's extensive efforts to promote this idea and to explain the rationale to tax authorities and legislators. As discussed earlier, the current tax law continues to offer an extremely narrow set of rules with respect to the tax positions of the parties involved in corporate reorganizations. The current lack of detailed and specific tax accounting rules opens up areas for potential disputes with tax authorities, and taxpayers may need to adopt conservative tax positions in the their planning and be prepared to face challenges from the authorities.

As Kazakhstan's tax law evolves and becomes more comprehensive and sophisticated, it will presumably begin to address corporate reorganizations in more detail, including introduction of certain tax-free reorganization rules. In the meantime, taxpayers would be well-advised to seek professional tax advice to make an informed decision regarding the tax implications that a corporate reorganization potentially invokes.

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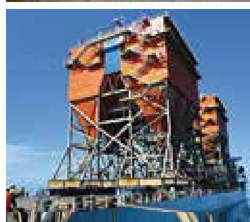

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