GOVERNMENT OF THE FEDERATED STATES OF MICRONESIA

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Secretary of Finance
&
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Tax Ruling 18-04

Subject: Public Ruling on Corporate Tax Treatment FSM Corporation Merger with an Affiliated Foreign Corporation

Issue

Under the following situation, when a Major Corporation merges with a foreign corporation which is affiliated with the Major Corporationand the foreign corporation is the surviving entity, what is the tax treatment of the merger?

Situation

Major Corporation X is incorporated under the laws of FSM. Major Corporation X is owned by a single shareholder that is incorporated under the laws of Country B. Major Corporation X seeks to merge with Foreign Corporation, which is affiliated with Major Corporation X, under the procedures laid out in the FSM corporate law (Title 36). Foreign Corporation is incorporated under the laws of Country C, and will be the surviving entity. Foreign Corporation will succeed to all of Major Corporation X's assets and liabilities. The transfer does not involve an exchange of cash or shares, only an outright transfer of the assets and liabilities of Major Corporation X to Foreign Corporation. Country B utilizes the GAAP standard which provides that the transfer of assets and liabilities of a corporation to a surviving corporation in a cross-border merger shall be valued at fair market value for purposes of determining the tax treatment of the transaction.

Applicable Law and Analysis

54 F.S.M.C. § 321 provides that, "A tax at the rate of 21 percent (21%) is . . . imposed for each taxable year on the taxable income of every major corporation." "Taxable income" is defined as a corporation's income "before income taxes, earned in the taxable year as determined under International Financial Reporting Standard (hereinafter, "IFRS") or Generally Accepted Accounting Principles (hereinafter, "GAAP"), as IFRS or GAAP, as the case may be, is regularly utilized to calculate taxable income in the major

corporation's principal shareholder's, if a corporation, place of incorporation or, if an individual, country of primary residence." 54 F.S.M.C. § 322.

Subpart 2.2 of the Regulations for Public Law 13-71, the Corporate Income Tax Act of 2004 (the "Regulation")defines the amount to be included in gross income and gross expense:

> *2.2 Computation of Taxable Income*
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> (2) In computing taxable income, the amount to be included in gross income shall be, unless otherwise provided in these regulations, the amount of income in the stated Taxable Year from:
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> (a) sale of assets;
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> (b) gratuitous transfers of assets;
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> (c) rendering of services;
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> (d) gratuitous acquisitions of assets; and
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> (e) any transactions other than capital transactions.
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> (3) In computing taxable income, the amount to be included in gross expense shall be, unless otherwise provided in these regulations . . . the cost of sales, cost of completed construction work, and other similar costs related to income during the Taxable Year;
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> (4) The amount of income in the Taxable Year prescribed in Subpart 2.2(2) and (3) hereinabove shall be computed in accordance with GAAP as prescribed in Section 322 of the Act.

Subpart 2.2(2) of the Regulations identifies the "gratuitous transfer[] of assets" as a situation to be included in the calculation of taxable income. Section 322 of Title 54 of the FSM Code states that income must be declared in accordance with International Financial Reporting Standard (IFRS) or Generally Accepted Accounting Principles (GAAP) as such standards are utilized in the major corporation's principal shareholder'splace of incorporation. Country B utilizes the GAAP standard which defines "gratuitous transfers of assets" as a transfer of property for less than the fair market value of the property. Under the GAAP standard utilized by Country B, the transferred assets and liabilities of a corporation, including shares, to an affiliated company shall be valued at fair market value for purposes of determining the tax treatment of the transfer in connection with a cross-border merger with an affiliated foreign corporation.

Ruling

1. When merging with an affiliated foreign corporation that will be the surviving entity, a Major Corporation must revalue the assets and liabilities to a fair market value as of the date of merger for corporate tax purposes.
2. Fair market value is the estimate of the price a willing buyer and a willing seller would agree to.
3. A taxpayer Major Corporation is required to submit the final corporate tax return dated as of the date of the merger of the Major Corporation with the affiliated foreign corporation.
4. A taxpayer Major Corporation must utilize a qualified third-party appraiser to determine fair market value. However, if the assets of the taxpayer Major Corporation consist solely of (1) cash (foreign currencies and currency equivalent) and (2) marketable securities traded on a reputable public market, then the Major Corporation may value these assets with reference to (1) the foreign exchange rate quoted by internationally reputable banks, and (2) the last traded price of the securities on the public market, on the date of the transfer.
5. Third-party appraisals (or the other information mentioned in 4 above) must be attached to the final tax return.
6. The Secretary retains the right to request further information regarding the appraisal, including, but not limited to: the method used for determining fair market value and the qualifications of the third-party appraiser.
7. The Secretary retains the right to utilize appraisers hired by the Department of Finance and Administration to determine the fair market value of the assets and liabilities of a mergingcorporation.
8. The Secretary retains the right to inspect and audit company merging with an affiliated foreign company if the company's tax liability from a gratuitous transfer of shares to an affiliated foreign company is not paid prior to filing for merger.
9. The taxpayer Major Corporation may request the Secretary of Finance to allow in-house valuation in certain circumstances including minor assets under $10,000.

Sihna N. Lawrence
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