



Carve-out
financial statements
Tax considerations
and complexities

Tax considerations and complexities you need to know for carve-out financial statements

Divestitures, including spin transactions or the selling off of a division, unit, product line, plant, pool of assets, or other part of a company, have long been included in the merger and acquisition equation. As companies refocus on their core strategies to sustain future growth, many are finding that the divestiture component of transactions has grown in size and complexity. Determining the information related to tax provisions (balance sheet, expense and benefits, etc.) is often one of the most complex aspects of preparing carve-out financial statements in conjunction with a divestiture.

The divestiture process and key financial statement issues

The accounting and tax functions should play a key role throughout the entire divestiture process, but their involvement in the process is most critical:

- During pre-sale planning, when companies have the opportunity to identify and address potential tax and accounting issues.
- During closing, when companies identify information needs and develop carve-out financial statements.

There is no single source of guidance on carve-out financial statements. Companies may look to the SEC's guidance and industry-specific sources, but ultimately they must exercise judgment about issues such as basis of presentation, cost allocations, and the assignment of assets and liabilities to the carved-out business. This can be challenging when the operation to be divested has been embedded within a broader organization and the parties must now account for it as if it were a separate operation.

Divesting organizations typically prepare one of two types of financial statements:

- SEC-compliant financial statements with footnotes, cash flows, stockholders' equity statements, etc.
- Abbreviated financial statements that include statements of revenues and direct expenses, and of assets and liabilities to be sold.

Full financial information may not always be attainable or the preparation of such statements may be too time-intensive or cost prohibitive. In these instances, public companies are required to obtain permission from the SEC to use abbreviated financial statements.

Legal entity structure

Understanding the legal structure of the operations to be carved out is critical to preparing financial statements. Tax professionals can add a great deal of value during the earliest stages of this process.

While the carve-out may represent an entire segment or division of a larger group, the accounting and financial reporting data associated with a particular operation may be compiled differently from that used in tax returns, which are prepared on a legal-entity basis. It is beneficial, therefore, to determine which legal entities comprise the business segments or divisions to be carved out. Taking the time to complete this exercise will help tax professionals determine whether relevant tax information exists for these entities and the best way to extract the data needed for carve-out tax provisions.

An organization's legal entities often include certain assets that may be carved out and certain assets that may stay behind. Identifying these assets enables the organization to determine the best way to allocate, if necessary, the deferred-tax-related items associated with the net assets to be bifurcated. Further, a careful examination of the organization's legal entity structure may also help tax practitioners identify the particular jurisdictions — both state and foreign — where the business will operate after the carve-out. To the extent that these jurisdictions differ from the organization's traditional operations, statutory tax rates and compliance with applicable tax laws may affect the financial statements. Finally, it is important to consider the funding of the federal, state, and foreign tax liabilities because such funding may affect presentation within the financial statements.

Materiality

The company's tax team also should assess the size of the carved-out operations relative to the size of the entire company. If the carved-out operations are small relative to the entire group, amounts that are not material to the consolidated group may be material to the carved-out operations. Consequently, the company may need to:

- Establish an inventory of temporary differences that corresponds to the assets and liabilities that are being carved out.
- Consider whether it needs a valuation allowance to offset deferred tax assets for the carved-out operation.
- Determine whether it is necessary to record unrecognized tax benefits in the stand-alone financial statements.
- Identify the records that exist and whether those must be augmented to support the carve-out financial statements.

Audit scope

If the carved-out operations have previously been subject to audit-level scrutiny, it is possible that the testing applied to those operations during the previous annual audit processes was less rigorous than the testing that would be required in a stand-alone audit of those operations; thus, audit scope may become an issue. The company should work with its external auditor to ensure that the company's internally prepared tax provision schedules and analyses that were used to support prior audits will serve as sufficient documentation for the carve-out statements.

Deferred taxes

The opening balance sheet is a starting point for discussions with the external auditor to determine the most appropriate approach for determining deferred taxes. Options include:

- A top-down approach, which allocates previously tested and reported balances.
- A bottom-up approach, under which a new stand-alone set of deferred tax assets and liabilities is created and then tested by the external auditor.

In some situations, it may be easy to identify the deferred tax assets and liabilities that should be reported in the carve-out statements. When deferred tax items are not readily identifiable (e.g., a Section 263A¹ adjustment calculated on the basis of absorption percentages that are not identifiable in the carve-out context), the company must allocate these deferred items by using a reasonable method (e.g., the assets to be carved out as a percentage of the consolidated total for that category of assets).

¹ Internal Revenue Code Section 263A, "Capitalization and Inclusion in Inventory Costs of Certain Expenses."

Companies would typically use the finalized temporary differences that appear on the filed tax returns to build the inventory of deferred tax assets and liabilities at a particular year-end. If the tax returns have already been prepared, the company might use actual return amounts rather than estimates, and timing differences should generally agree to consolidated or pro forma tax returns.

This approach may yield deferred assets and liabilities that differ from those previously recorded for the carved-out operations in the prior year's tax provision. This disparity is because of tax return true-ups that, within the carve-out setting, will be recorded in the appropriate periods. Companies should analyze the differences to determine whether they result from information that existed as of the date of the financial statements or from new information or developments related to the subsequent period.

Calculating and reporting deferred tax assets associated with the company's attributes (e.g., net operating losses (NOLs) and various credits) pose unique challenges in the context of carve-out statements. A company should start by tracking the attributes and related deferred items associated with the legal entities that comprise the carve-out statements. Such attributes may be further adjusted for any accounting push-down adjustments (discussed further below) that are recorded as part of the carve-out process. Because carve-out adjustments may be needed to show how the company would look if operating on a stand-alone basis, the ending deferred tax asset balance associated with the carved-out entity's attributes may not ultimately reflect the actual attributes that may be available for use after the carve-out. For such attributes, the adjustments the

entity made to reconcile between the theoretical carve-out approach and a strict legal-entity approach would either be reflected in pro forma adjustments (if required) or recorded by the acquirer in purchase accounting. The tax footnote should include disclosures about (1) NOLs either produced or used by the carved-out operations and (2) the nature of those NOLs and whether certain credits or attributes will be allocated to the carved-out operations. If the tax attributes recorded in connection with the carve-out are materially different from those actually assigned to legal entities that comprise the carve-out group (primarily resulting from carve-out adjustments), it may be necessary to add comments in the tax footnote to explain the discrepancies.

The company should determine whether it is more likely than not that the carved-out operations will realize deferred tax assets and carryforward attributes in the future. If not, it should determine an appropriate valuation allowance and allocate it ratably between the current and noncurrent deferred tax assets. Typically, the company must perform scheduling exercises in making the valuation allowance determinations. In addition, the company should carefully assess the appropriate level of valuation allowance when dealing with temporary differences associated with indefinite-lived intangible assets (because such deferred items cannot generally be scheduled out). Unlike the preparation of the company's inventory of temporary differences, the determination of whether a valuation allowance is necessary should not take hindsight into account. Therefore, the valuation allowances should incorporate the best information available as of a given historical balance sheet date.

Tax effect of accounting push-down adjustments

To comply with the accounting requirements for a stand-alone company, an organization may need to push down certain transactions and balances, such as corporate overhead expenses and various reserve balances, to the carve-out financial statements.

Companies may need to allocate equity compensation arrangements, including options and restricted stock units, from the consolidated group to reflect the stand-alone nature of the carved-out operations.

These adjustments often require significant coordination between the accounting and tax functions because they may influence the effective tax rate calculation or the inventory of deferred tax items. Companies must consider each adjustment separately to determine the appropriate tax treatment. For example:

- Adjustments, such as meal and entertainment expenses, allocated to the carved-out operations will give rise to a permanent difference that will affect the effective tax rate.
- Some adjustments, like those that affect reserve balances or intangibles, may result in temporary differences and therefore will necessitate adjustments to the deferred tax balances.
- Companies must closely review pre-tax book income adjustments that would generally correspond to temporary differences (e.g., unrealized foreign currency gains and losses, certain equity compensation) to determine whether the corresponding balance sheet accounts are also pushed down to the carve-out financial statements. Since temporary differences are the result of basis differentials between book and tax balance sheet amounts, it may not be appropriate to book a deferred tax balance related to these items if the pre-tax balance sheet account (e.g., deferred

compensation liability) is not also included in the carve-out financial statements. Rather, it may be more appropriate to treat the income statement item as a permanent difference if it would not have been currently deductible (or currently taxable).

Consolidated tax adjustments

In addition to pushing down certain accounting transactions and accounts to reflect the stand-alone nature of the carved-out operations, companies will need to use an acceptable systematic and rational method, such as the separate-return method (subject to the attribute method discussion above), to recalculate certain tax adjustments. (The SEC views the separate-return method as preferable. If a different method is used, the SEC will also require a pro forma income statement that uses the separate-return method.) Examples of adjustments that companies may need to calculate include:

- Section 199² deductions.
- Charitable contribution carryforwards.
- Research and development credits.
- Foreign tax credits.

Taxes payable balance

The calculated amount of federal and state taxes payable in the carve-out financial statements is likely to be different from the amount previously booked and paid by the entities that comprise the carved-out operations. Although the carve-out process involves updating financial information to present these operations on a stand-alone basis, the process would not affect previously filed tax returns or the amounts paid by those entities to the parent under the tax-sharing agreement. As a result, the taxes payable or receivable balances calculated on a carve-out basis will not result in corresponding cash tax payments or receipts. Generally, the carved-out operations will include subsidiaries that joined in consolidated tax filings

² Internal Revenue Code Section 199, "Deduction Relating to Income Attributable to Domestic Production Activities."

for which the parent entity funded the tax liability or collected a refund. A tax-sharing agreement may be used to dictate whether cash for taxes paid and received is collected from, or pushed down to, the carved-out operations.

Companies will generally prepare the tax provision for the carve-out statements by using the separate-return method, in which taxable income or loss is calculated as if the carved-out operations represented a taxable group that is separate from the existing parent. The taxes payable or receivable balance should be computed in a corresponding manner. Generally speaking, companies should compute the payable or receivable balance as follows:

1. Calculate the carve-out group's current tax expense or benefit on a separate-return basis. That result represents the amount of payable or receivable that would have been recognized if the carve-out group had existed on a stand-alone basis (i.e., the basis generally used in preparing carve-out financial statements).
2. Adjust the payable or receivable balance from step 1 above to reflect the actual cash tax payments made or received by the legal entities that comprise the carve-out group to or from other members of the consolidated group (generally the parent).
3. Generally write off any remaining payable or receivable balance to equity at the end of the year since it does not represent a true liability or asset. In certain circumstances, companies may need to settle outstanding amounts pursuant to the tax-sharing agreement. In these cases, some remaining receivable or payable is shown until those amounts are settled or forgiven in connection with the spin-off or divestiture.

This approach should yield a tax expense or benefit and related payable or receivable that closely mirrors the amounts that the carved-out entities can expect to pay or receive annually.

Companies should also consider the effect of movement in the taxes payable balance on the statements of cash flows and equity. Generally, the statement of cash flows includes an operating cash flows addback for total income tax expense and an operating cash flows reduction for actual cash tax payments. The statement of cash flows in carve-out financial statements needs to include an equity adjustment related to cash taxes to the extent that such cash taxes are settled through equity or never settled. It may be appropriate to include this equity adjustment in the financing section of the cash flows statement if the cash tax payments related to the carved-out operations were historically made by a parent company that is excluded from the carve-out group.

State tax considerations

Companies with multistate operations will have various considerations in a divestiture. For example, the carved-out operations may:

- Be located in states that are different from those of the consolidated group's other operations.
- Have a portion of income taxed in a state where they do not operate because of a unitary filing requirement.
- Operate alone in a state that requires a unitary filing and therefore subject the consolidated group's income to tax in that jurisdiction.

Individual state tax rates for the carved-out operations may be different from those typically applied to the consolidated group. Companies should therefore recalculate the apportionment for the carved-out operations on a stand-alone basis to determine a reasonable blended state statutory tax rate; however, it is possible that the recalculated rate will not differ materially from the consolidated group's calculated effective state statutory rate. Further, companies should consider whether the use of separate filings, instead of

unitary state filings, could cause a shift in state tax rates. It may be difficult to gather the supporting information, particularly when (1) the carved-out operations are considerably smaller than the consolidated group and (2) state taxes have historically been booked at one standard state tax rate. Companies may therefore need to review past state tax returns, as well as apportionment workpapers prepared on behalf of the legal entities that comprise the carved-out operations, to determine how income can be apportioned on a stand-alone basis.

International tax considerations

If the carve-out group operates globally, companies should consider international tax implications including, but not limited to, the following:

- The need to extract carved-out operations from an existing foreign consolidated group or single legal entity.
- Identification and use of foreign specific tax attributes and NOLs.
- Intercompany transactions that may be eliminated on a carve-out basis.
- The size of the carved-out operations in a particular jurisdiction.
- The effects of intercompany financing transactions.
- Previous international structuring transactions, including U.S. check-the-box elections.

Further, companies may need to prepare separate tax provision calculations for each material jurisdiction in which the carved-out operations take place. Doing so will allow tax practitioners to apply the appropriate tax rate on a jurisdictional basis and determine the appropriate treatment of the carve-out adjustments on the basis of local country tax law.

Companies should consider whether there is a need to reevaluate an indefinite reinvestment assertion and whether the assertion changes

because of the carve-out. Specifically, companies should review the cash requirements of the new stand-alone group, previous global repatriation decisions related primarily to operations outside of the carve-out group, and the ability to offset repatriation liabilities with foreign tax credits. This analysis may be complex; companies should consult qualified advisers.

IFRS considerations

Companies should also consider whether the financial statements should be prepared in accordance with U.S. GAAP or International Financial Reporting Standards (IFRSs). Depending on the intended audience for the carve-out financial statements and where the statements will be filed, a conversion to IFRSs may be an important or necessary component of the project. A detailed discussion of IFRS conversion is beyond the scope of this document; however, companies that are contemplating a conversion to IFRSs in connection with the carve-out should consider the following:

- *Order of operations* — A decision that the financial statements should be converted to IFRSs and then carved out or vice versa may significantly affect the planning and resource needs for the project.
- *Technical accounting differences* — Accounting for income taxes is not substantially converged under U.S. GAAP and IFRSs. As a result, numerous technical differences must be addressed, including some that may involve complex computations or additional data that are not readily available. Areas of potentially significant tax accounting difference include:
 - Share-based payments.
 - Uncertain tax positions.
 - Intercompany transactions.
- *Effects of other pre-tax accounting differences on income tax accounting* — Considerations include revenue recognition, inventory accounting, and lease accounting.

The degree to which a company will be affected by accounting differences between IFRSs and other accounting standards will depend on the company's facts and circumstances. If the company must convert the financial statements in connection with the carve-out process, consultation with an IFRS tax expert is critical.

Uncertain tax positions

The consolidated group may have some unrecognized tax benefit liabilities (as described in FIN 48,³ now codified in ASC 740⁴) related to the carved-out operations. In such a case, the company's consolidated balance should be considered, and a reasonable approach (i.e., identification or allocation) should be determined for assessing how much of the overall liability is attributable to the carved-out operations. The actual legal obligation of the uncertain tax position must first be considered on a legal-entity basis. Once legal obligations are determined, additional analysis may be necessary. For example:

- If the parent company will retain liability for uncertain tax positions, including those related to the carved-out operations, it may be necessary to include unrecognized tax benefits, as well as a receivable evidenced by an indemnification agreement with the parent company, in the carve-out financial statements. If the carved-out operations gave rise to the uncertain tax position (regardless of which party bears the contractual obligation), it may be appropriate to include the impact in the carve-out tax provision.
- In contrast, if the carved-out operations will, as part of a tax indemnification agreement, retain liability for specific uncertain tax positions related to legal entities not included in the carve-out group, it may be inappropriate for the change in those balances to be included in the tax provision in the carve-out statements. In this scenario, the company may need to adjust the net parent investment to ensure that the balance sheet accurately reflects the liabilities that will exist after the divestiture.

Tax footnote disclosures

Unless carved-out operations are preparing abbreviated financial statements, they should expect to present a tax footnote disclosure that is consistent with the company's full financial statement presentation. Such disclosure should include:

- An effective tax rate reconciliation. Operations involving multiple jurisdictions should consider whether the statutory rate is a blended rate based on those jurisdictions or a single rate based on the predominant location.
- A summary of the current and deferred tax provision.
- A schedule detailing the deferred tax assets and liabilities.
- If necessary, an unrecognized tax benefit reconciliation with appropriate disclosure language.

In addition to the various tables, the carved-out operations should consider using the text of the footnote to explain how certain items unique to the carve-out were treated for tax purposes. This might include:

- Comments on the legal structure and how the operations themselves are treated for tax purposes (e.g., separate return versus consolidated group).
- Push-down of tax attributes so that investors may consider the value that the operations will derive from using these attributes on a post-transaction basis.
- The method used to determine the payable or receivable balance.

³ FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*.

⁴ For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

Interim updates

If the statements will be publicly filed, companies may need to prepare interim financial statements in addition to the annual carve-out financial statements. Generally, companies would use a projected annual effective tax rate (for the carved-out operations) adjusted by discrete items for the interim period. Under this approach, companies determine an interim provision in the carve-out financial statements that is likely to be comparable to the consolidated historical interim reporting.

For example, as a starting point in its calculation of the interim provision, a company would typically analyze its historical projections to determine whether they are still appropriate for the carved-out operations.

At times, however, retrospectively determining the appropriate annual effective tax rate for interim reporting for carve-out financial statements can be particularly difficult. In these instances, a company might consider using the actual annual carve-out financial statements as a surrogate for interim projections, and then adjust the annual effective tax rate for items that would have been accounted for discretely to determine the projected annual effective tax rate. Because use of this type of approach would be limited to unique circumstances, advance consultation with tax advisers or auditors is strongly recommended.

Conclusion

Although a divestiture is often a significant event in the life of a corporation, up-front planning can ease the burden on the organization and increase the likelihood of a successful transaction. For companies that will prepare carve-out financial statements, such planning should include the involvement of tax professionals and advisers in the earliest phases so that the tax matters discussed in this document can be addressed before the real work begins.

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