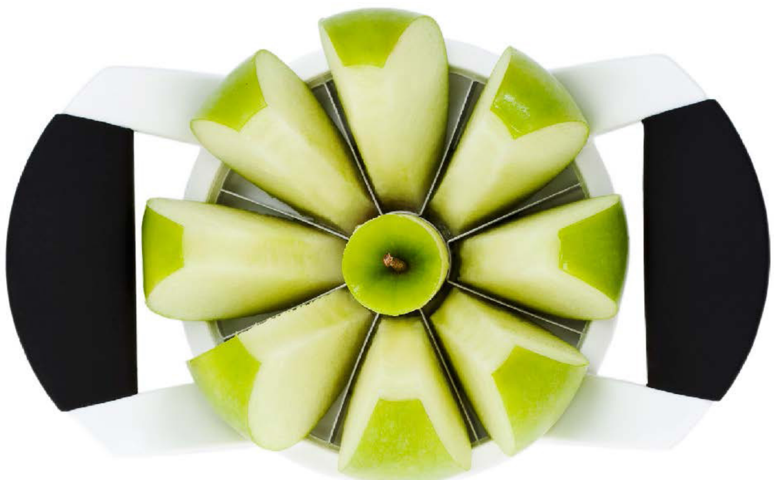
The hidden tax value in divestitures

Why looking beyond the deal may be valuable



If you're planning a spin-off or carve-out, you know how important tax considerations can be to realizing the full value of your transaction. But did you also know that a separation may offer significant opportunities to improve the ongoing tax efficiency of each separated business after the transaction closes — and thereby increase the transaction's long-term value? Our experience suggests that many divesting companies tend to overlook this group of tax-saving opportunities. Here's how you can take steps to potentially increase value.

Hidden in plain sight

Some tax costs are pretty obvious, especially those associated with the transaction itself. For example, the tax that the selling corporation must pay when it disposes of a subsidiary or division is straightforward to quantify. Likewise, other transaction-related items (such as the taxation of executives' golden parachutes) are often of great personal interest to decision makers in any deal. These transaction-related tax costs and opportunities tend to get plenty of attention, so we won't dwell on them further here.

However, other tax opportunities that frequently present themselves in spin-offs and carve-outs are often overlooked. These opportunities are directly connected to changes in the underlying business of one or both companies, rather than being associated with the transaction itself.

Many organizations, in our experience, simply don't focus on these opportunities until well after the deal is done, when it's usually too late to factor tax considerations into operational decisions about the newly separated entities. And it's not just the business being sold that ought to consider these opportunities. Depending on the size and nature of the divestiture, the parent company may also need to change its business operations to suit its new size and scope. The tax implications of these business changes can have a far-reaching impact on each company's performance going forward. Every business process that is changed represents a legitimate opportunity to establish the new company's operations in a more tax-efficient manner.

Why do organizations sometimes fail to act? As noted above, the tax issues that tend to take center stage are often those related to the transaction itself, such as obtaining tax-free status for the spin-off, increasing the deductibility of transaction costs, and addressing the taxation of golden parachute payments. Any tax department energy left over from those issues is generally absorbed by the challenge of setting up the separated businesses' tax operations so that each can continue to function after the transaction. With all that to worry about, it's not surprising that analyzing the tax implications of the separated entities' new business processes can fall off the radar.

Fortunately, once the idea of increasing the tax efficiency of the new entities' changed operations is brought to the divestiture team's attention, it's relatively straightforward for tax personnel to do the necessary work to advise management appropriately. In spin-offs and carve-outs, unlike in mergers and acquisitions, information can usually be freely shared between the soon-to-be-separated businesses, making it feasible to start planning each company's operational structure well in advance of deal close. Moreover, in a pure spin-off, the divesting company normally has more control over the timing of the transaction than it would have in an acquisition. In short, if you're considering a divestiture, there are no good reasons not to consider the tax implications of operational decisions associated with the separated entities.

Places to start looking

So what areas of operations might benefit from a good look at their tax implications? Almost any planned business change should be considered, but especially those that involve relocating personnel, facilities, or assets. Here are a few of our top candidates:

Supply chain — A newly independent company usually needs to establish its own supply chain separate from its parent's. If the divested company is large, the parent may also need to make changes to its supply chain. In both cases, there may be opportunities to reduce federal, state, and foreign income taxes.

The use of a "procurement company" is one well-known example. Large companies often centralize their sourcing and procurement activities to achieve economies of scale. A company with such a centralized procurement organization may be able to realize savings, including tax savings, by isolating its procurement functions and assets in a separate legal entity — a procurement company — particularly when that company is located in a low-tax jurisdiction. The rest of the organization, which may be located in higher-tax jurisdictions, pays the procurement company to provide sourcing and procurement services; the overall tax savings occur because the procurement company's income is taxed at a lower rate than would have been the case if the assets had remained with the rest of the organization. Another advantage of this type of structure can be a potential reduction in recurring sales and use taxes on goods and services flowing through the procurement company.

Technology — Considering the tax profile of different jurisdictions can be important when determining the location for information technology (IT) assets and activities. If a company uses technology to perform a high-value, well-defined function — for example, a hotel chain that uses a proprietary room reservation system — the company should consider housing the IT assets and activities used for that function in a discrete legal entity located in a lower-tax area. Like a procurement company, this IT entity charges the rest of the enterprise for its services, and its income is taxed at a lower rate. A spun-off or carved-out company should be especially cognizant of this approach, as a divested company generally needs to build its own IT infrastructure from scratch and will be faced with decisions regarding the location of that infrastructure.

In addition, a divested company may be able to avail itself of a wide range of tax-saving possibilities, both immediate and ongoing, as it builds out its IT infrastructure. For example, a variety of approaches exist to reduce sales and/or use tax paid on software and hardware purchases, and companies may be able to deduct, rather than capitalize, substantial portions of the total cost of an enterprise resource planning (ERP) implementation. Some jurisdictions also offer research and development tax credits for internal-use software projects, which may influence a company's choice of where to conduct its initial and ongoing software development. And training credits or grants may be available to companies that need to train or retrain its employees on new IT systems.

Facility location — Whether it's a warehouse or distribution center, a manufacturing plant, a data warehouse, or corporate headquarters, opening a major new facility often gives companies the chance to negotiate for tax credits and/or incentives with various tax jurisdictions eager to bring new business to the area.

These tax credits and/or incentives can range from property tax exemptions to corporate tax moratoriums to employee training and development credits. The more people to be employed at the proposed facility, the more

Common tax divestiture pitfalls

1. **Transaction taxes on asset transfers —** Sales, use, value-added tax (VAT), and other transaction taxes can significantly increase the cost of the deal. If these issues are discovered too late in the process, it can be difficult, if not impossible, to restructure the transaction to reduce these burdens.

2. **Tax-related transition service agreement (TSA) issues —** It's common for the parent company to agree to provide some tax support for a limited period of time until the divested company can staff up and develop the IT infrastructure to manage its own tax affairs. The mistake many companies make is not being specific enough in the TSA language. For example, what does it mean when the parent company says it will provide "sales tax support"? Does it mean that they will prepare the sales tax returns, or provide the data for the returns, or answer questions if asked? A substantial post-close dispute about roles and responsibilities may be avoided with more careful language.

3. **Payroll restarts —** Depending on the nature of the transaction, employee wage bases for Federal Insurance Contributions Act (FICA) tax may need to restart, a burden to those highly compensated employees who have already "topped out" for the year. (While the employee can later get a refund on a personal tax return for the excess FICA paid, the employer cannot.) A more common issue is restarting state unemployment tax bases. Since state unemployment tax base limits are smaller (only $10,000 or less in many states), it is not uncommon to have virtually the entire employee base be affected, and this can effectively double the state unemployment tax burden for the year of the transaction.

4. **Facility announcements prior to credit negotiations —** Many state and local governments will consider providing inducements to attract (or, in some cases, just maintain) employment in a specific location. But if a spun-off company announces where its headquarters will be located, before negotiating with the local authorities, almost all negotiating leverage will be lost.

5. **Nexus/Permanent Establishment refresh —** Often a spin-off or sale will reduce the tax footprint of one or both companies, which will reduce the number of jurisdictions where taxes must be paid. Unfortunately, certain tax departments sometimes simply follow what was done in the prior year, resulting in unnecessary filings and taxes.

significant these tax credits and incentives can be. Just as important, a divestiture may put existing credits and grants at issue, so a complete survey of the impact of the transaction is a must.

Researching and negotiating for credits and incentives, whether new or those to be retained, can take time, so it's important to start looking into these incentives relatively early in the divestiture process. By allowing plenty of time to negotiate with taxing authorities before announcing the location of the new facility or facilities, a company can protect itself from being hurried into a less-than-satisfactory decision. Of course, it will be all but impossible to negotiate incentives with local authorities after a location decision has been announced — one more reason to start the process early.

Liberating tax department resources

As noted above, tax departments of companies that are undergoing divestitures can easily be overburdened. One way to create capacity in your tax department can be to critically review new information systems from a tax perspective so that the tax department doesn't need to generate the data that proper IT systems can do automatically. For instance, if the separated company's IT system can't generate legal-entity books, the tax department will need to generate them by hand.

With foresight, an emerging tax department can shape its policies and processes through the use of technology and significantly reduce the time devoted to tax return compliance and planning while generating higher-quality products in both areas. Here, a "clone and go" approach with respect to existing IT systems may actually be problematic. Supported by an analysis of how the tax department gets from "here" to "there," the new tax department can emerge as a smaller cost center with a focus on a number of critical tasks, rather than solely on tax compliance obligations, which may be addressed through effective technology and data management planning.

The bottom line

Obviously, the decisions you make about the separated companies' operations will be shaped by many business considerations other than tax. Our view, though, is that tax should be considered early in the process so that management can make operational decisions based on an after-tax rather than a pre-tax basis. While tax considerations shouldn't drive these choices, they're definitely an important part of the total picture, and they can have long-lasting consequences for the separated businesses.

Remember, too, that it's usually far easier to address the tax efficiency of a business as part of an overall business transformation than it is to make changes once the business has stabilized. In other words, once the business processes are set in stone, the tax consequences may be too — and you may find your future tax options somewhere between slim and nonexistent. Even worse than missing a potential tax opportunity, you may find yourself locked into a very undesirable tax position with only limited options for improvement. So take the time to look for ways to achieve tax efficiencies in the separated businesses' operations when you engage in a spin-off or carve-out.

Contacts

Pam Beckey
Partner
Deloitte Tax LLP
+1 617 437 3284
pbeckey@deloitte.com

Russ Hamilton
Partner
Deloitte Tax LLP
+1 214 840 7506
ruhamilton@deloitte.com

Chris Kontaridis
Principal
Deloitte Tax LLP
+1 617 437 2821
ckontaridis@deloitte.com