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Tax considerations during M&A integration

Shaping the new organization

Tax executives should lobby for a seat at the table with their C-suite counterparts during M&A integration planning, for they can offer important insights and recommendations to accomplish strategic tax goals associated with the transaction. Their involvement should begin early, extend through the integration lifecycle, and address key business decisions, synergy prioritization, legal entity readiness, and countdown to Day 1.

First 100 days sprint

Prior to and after the announcement of an M&A transaction, tax executives can play a valuable role in helping senior management determine synergies, identify pre-and after-tax benefits, and improve business processes. To be effective, tax department leadership should consider focusing on two things: the clear-cut business tasks that need to be addressed and the fuzzier (but equally real) human ramifications of the transaction. This is easier said than done, as tax executives must also manage their day-to-day responsibilities and plan for the first combined financial statements.

The first area, M&A-related tax business tasks, involves checklists, memos, work plans, and other tax technical details. The second, taking care of people, requires managing the uncertainty that inevitably ensues when an M&A transaction is announced–employees at all levels likely are anxious about their future and their new or changing responsibilities.

Although every M&A transaction is different, the focus areas for tax executives usually fall into three categories:

1. Deal-related tax technical aspects
2. Tax department operational needs; and
3. Business process changes.

Many tax executives and department professionals find managing a transaction's tax technical aspects to be particularly interesting and rewarding. Issues may include determining the deductibility of transaction costs, addressing executive compensation, and strategically placing acquisition debt to maximize the tax benefit of the future interest expense. The tax department can grapple with these and other tax technical topics in an ad hoc manner, outside of the context of the overall business transformation.

However, tax technical issues are just the beginning of the process. A tax department's broader operational needs also have to be addressed. Issues include changes to the ASC 740, Accounting for Income Taxes, compliance needs (including data, process, and technologies), completion of necessary stub-period tax returns, tax department design, tax authority audit management, and information technology needs.

Managing operational category issues represents the minimum table stakes for a company's post-transaction survival. Overlooking an issue in the tax technical category—perhaps failing to place the acquisition debt in the optimal subsidiary—will not prevent the sun from rising tomorrow. However, overlooking an issue in the second category—for example, a botched tax provision in the first quarter after the deal closes—could have immediate and severe consequences for the company and its tax department members. In our experience, many tax executives focus exclusively on tax technical issues in the beginning, but quickly divert their attention to tax department operations when they realize the potential consequences and visibility of failure in this area.

The third category involves business process changes that are inherent to strategic deals. In an M&A transaction, the acquiring company usually does not buy the target just to hold on to it passively and collect dividends. Someone at the executive level determined that the two companies would be worth more combined than as separate entities. This implies the existence of certain synergies, mutual support capabilities, and complementary traits that should be identified and assessed for their potential tax impacts.

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M&A transactions typically follow a logical rhythm and sequence. With proper planning, tax departments can use these transactions to advance certain strategic initiatives that may have been on hold. During the months immediately following a deal's announcement, it will be crucial to know what the operational and financial groups will be expecting from the tax executive — and what they might not think to ask, but should.

Tax executives likely will, and should, be called upon to contribute to the most important initiatives shaping the new organization. It's critical, then, that the executives and their staff proactively address the issues, challenges, and opportunities that an M&A deal may bring. This may require them to venture outside their comfort zone of dealing with day-to-day, department-specific tasks.

Keep tabs on changing business processes

It stands to reason that existing, underlying business processes usually must be changed to achieve post-transaction synergies. The tax department can play an important role in this transformation, particularly by helping to reduce the tax cost of the process changes. Yet tax executives commonly underestimate the speed and scale of business process changes. As a result, these changes often are implemented without considering the tax consequences, sometimes with devastating impact to the business.

Consider this hypothetical example: As part of an M&A transaction, two of three facilities will be closed; the third will stay open and add employees. The company's operations group may be moving forward on business decisions without taking into account possible tax ramifications or opportunities. The tax executive could offer ways that the department could add value. For instance, if the operations group was trying to decide which of two facilities to keep open, the tax department might be able to quantify the relative tax burdens of the two locations to support deliberations. As soon as the choice was made, but before staff increases were announced, the tax department could help negotiate certain incentives or assess overall tax impacts associated with strategic decisions. Furthermore, the tax executive could advise the operations group on how the proposed facility shutdowns might impact the company's global transfer and advance pricing agreements.

This situation illustrates why tax executives need to make sure that they have a seat at the M&A planning table alongside their peers as early as possible – certainly before the transaction closes – if such process synergies are crucial to deal metrics. Strategic companies begin to plan for and implement business process changes immediately, and unless tax executives are aware of them from the start, they may not be able to add value.

Tax executives should expect that keeping tabs on M&A-related business process changes while simultaneously dealing with tax technical issues and tax department operational requirements may be a challenge. Many executives are tempted to just leap into the fray, working later and later each night to handle the multitude of responsibilities. We have frequently seen this approach fail. At a minimum, the executive will lose the opportunity to thoughtfully weigh the competing merits of proposed business process change options. More importantly, the executive may struggle with prioritizing and executing key tasks. This can make for a very long and uneasy first few months post-transaction with the executive worrying that something important was missed.

Our experience suggests that rather than jump in feet first, tax executives should take time at the outset of the deal lifecycle to develop a detailed work plan. This will require extra time and effort at a stage when time is a very precious commodity; however, every hour spent planning in advance can eliminate numerous hours of rework or wasted effort later.

A detailed, actionable work plan should cover all important aspects of tax technical, tax department operations, and business process changes. This disciplined approach will prioritize the department's efforts over the coming months and highlight, early on, any tasks that it does not have the proper resources to address. This way, the executive can obtain external assistance, such as temporary staff, as needed. Indeed, since overstaffed tax departments are a rarity today, calling for external assistance for the heavy post-transaction workload may be critical to the tax staff's well-being.

Take care of department employees

As previously noted, tax department employees may be more concerned about the outcome of the transaction than the executive. Because they have much less access to information, they may assume that the executive is withholding bad news; for example, that a move to the other company's location is imminent, that a top lieutenant may be demoted below someone from the other company, or that there might be wholesale layoffs. This stress is often amplified by headhunters calling department staff and, sometimes, spreading rumors of disaster.

Once a deal is announced, most companies have their integration teams quickly running at top speed in order to expedite the realization of announced and anticipated synergies. Accordingly, a tax executive's first step is to promptly identify key integration team members and present to them the business case for tax department participation. Step two for the executive is to identify tax resources that can be fully dedicated to the integration effort. Once it is underway, it is sink-or-swim. Therefore, the executive's third step is to invest department resources in the integration program. One cautionary note: Meeting the goal of proactive participation may be impaired if the individuals assigned to the integration team still have to spend considerable time on the tax provision or other operational support duties. What to do? The executive should provide tax department employees with as much information as possible, as soon as possible, in an open and frank manner.

Legal entity rationalization

One potential M&A-related issue is combining and simplifying two legal entity structures. These complex structures tend to drive up costs enterprise-wide, so it's little wonder that cost reduction is perhaps the most common driver of legal entity simplification efforts. But to achieve these cost savings, a company should embark upon an entity rationalization project, which can cost considerable time and money.

Company leadership will often request an estimate of potential cost savings before authorizing legal entity simplification. In the past, many companies have relied on a cost-savings threshold before moving forward on each potential simplification step. However, such high-level estimates are often poor predictors of actual results. Below is a more rigorous method for estimating the cost savings that are possible with entity reduction efforts. With respect to pre-tax cost savings, most companies that conduct a legal entity simplification effort in conjunction with or shortly after a major transaction can potentially benefit in some or all of the following areas:

Legal Entity Rationalization Savings Opportunities

Business Unit	Summary of Potential Savings
Legal and regulatory	Reduction in fees and costs relating to redundant minimum taxes, licensing, permitting, registration, registered agent, public notices filing, record maintenance, state legal, tax compliance, and other filings.
Finance and treasury	Reduction in bank account service fees, transaction charges, capital costs associated with minimum deposit requirements, debt covenant compliance, and cash forecasting.
Accounting	Reduction in fees and costs relating to statutory audit, redundant and inefficient shared services resources, monthly/quarterly/annual reporting, intercompany accounting (e.g., streamlining voluminous intercompany journal entries and reconciliations), statutory filings, and IFRS implementation.
Operations	Reduction in costs from duplicative administrative/shared services, misaligned operating model, duplicative insurance policies/premiums, and intercompany accounting. Reduction in lost sales/revenue resulting from artificial barriers to doing business.
Information technology	Reduction in costs relating to general ledger input/coding, system configuration, and incremental system capacity.
Human resources	Reduction in costs relating to administrative and shared services, insurance/premium, vendor rationalization, and redundant compensation and benefits programs. Managing loss of employee mobility.

Other derived potential benefits may include:

- **Risk reduction**—Aligning the legal entities with the company's business model may increase the likelihood of using the correct legal entity for contracting, employment, etc. Having fewer entities may also make it easier to generate accurate separate-company legal entity financial statements, which are necessary to produce correct tax provision amounts.
- **Ease of doing business**—Having fewer legal entities can make it easier for both customers and vendors to do business with the enterprise, especially if any particular customer or vendor must routinely transact with multiple entities within the group.
- **Tax reduction**—Additional legal entities can trap tax losses and other attributes, causing the overall group to have a higher-than-expected tax rate. For example, if the group's third-party debt is at the parent company and the profitable operations are at the subsidiary level, many states will not allow the parent's interest expense to offset the subsidiary's profits, resulting in loss carryforwards at the parent level and full taxation at the subsidiary level.

One danger to estimating cost savings on a per-entity basis is that the amounts can vary so widely as to be meaningless. For example, the annual cost to maintain a dormant US-based entity might be only a few hundred dollars a year. On the other hand, the cost to maintain a duplicative operating entity that does business in a European country might be more than several hundred thousand dollars per year. So, attempts to estimate cost savings based solely on the number of legal entities eliminated usually end in frustration. The critical dimensions of cost savings are:

- **Entity location**—US-based entities tend to have lower costs to maintain compared with other jurisdictions, which may have statutory audit and other entity-based requirements.
- **Entity activity**—Dormant entities can be easier to eliminate than operating entities, but dormant entities typically have a trivial cost to maintain compared to operating entities.
- **Simplification level**—Greater cost savings are possible when an eliminated entity's activities are completely absorbed into another entity's routine activities, rather than continuing to exist separately in the surviving entity. For example, larger cost savings are possible when an eliminated entity's bank accounts are closed, rather than simply being renamed with the surviving entity's name.
- **Prior integrations/restructurings**—Many complex legal entity charts are the result of prior M&A transactions. To the extent that the prior integration work was successful at achieving synergies (for example, the enterprise previously moved to a single ERP platform), there generally will be less cost saving available.

Entity simplification projects can yield substantial benefits, but they also can involve substantial costs. Before embarking on such an ambitious project, it is prudent to estimate not only the cost, but the likelihood of financial success, as well. The data, tools, and processes listed above can support enterprises as they attempt to quantify potential savings from an entity simplification project. As the project moves forward, tax executives should consider setting up a rigorous tracking process to identify and capture identified savings. Remember, the goal is not the reduction of entities per se, but the elimination of excess cost associated with the entities that are eliminated.

Factors for effective integration

Certain factors are important to achieve effective M&A integration:

- Having executive leadership support;
- Involving management from both the acquirer and target;
- Developing a detailed project plan that optimizes internal and external resources;
- Assigning a dedicated integration team; and
- Communicating transparently and consistently with employees.

Our experience suggests that companies add another factor to this list: Including the tax department among the functional groups participating in strategic decision-making around post-deal integration. Active tax department involvement across the integration lifecycle may significantly impact and improve overall synergy realization.

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