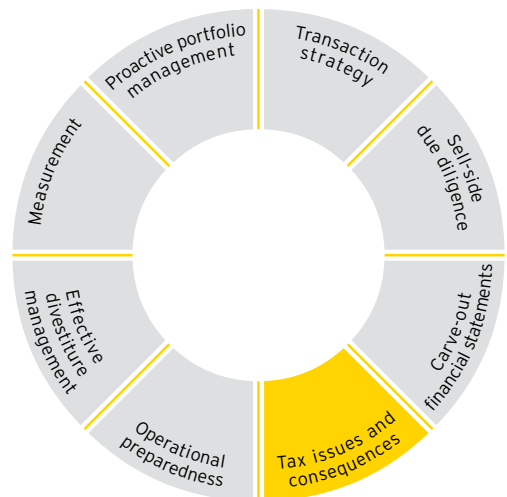


# Tax issues and consequences

In any divestiture, attention to tax issues can lead to more efficient deal structures and higher valuations. When cash and credit are scarce, tax considerations can make or break a deal.



by Todd Miller and Brett Enzor

## Key points:

- ▶ Introduce tax expertise early in the divestiture process
- ▶ Understand the assets being sold and their location and tax bases when determining deal structure
- ▶ Consider the complex tax issues posed by alternative transactions

By itself, taxation rarely drives divestitures. Asset or business disposals should make sense from a broader economic or strategic perspective. However, close attention to tax implications is always essential, owing to their complexity as well as to their potential to add considerable value to a transaction.

Today's marketplace features limited cash or credit available to fuel acquisitions, while many companies need to dispose of assets. Consequently, companies are exploring so-called alternative transaction structures that require less financing than a classic outright sale, and often bring complex tax-related implications.

## The tax process

Before embracing an alternative structure, sellers should work through a series of questions to identify the tax characteristics of the business as well as the tax needs of sellers and buyers. The first question - what assets are being sold? - must be answered with precision in order to address the second question, what is the tax basis of those assets?

The sale of individual assets generates a collection of individual gains and losses. Unless a company knows which assets are being sold along with their precise tax basis, it will be impossible to allocate the selling price all the way down to an individual asset or inventory and determine the precise gain or loss on the transaction.

Next question: where are the assets? Even if all are located in the US, there may be variations in city, county or state regulations that impact the calculation of tax basis. When

material assets reside in multiple countries, the calculations are much more complex. Not only do rules vary for determining tax bases, but each jurisdiction may tax gains or losses at differing rates. The value of gains and losses will be influenced by a company's overall international tax position. For example, the ability to generate losses on a sale may enable a company to offset gains from operations. There can be significant leeway in allocating the proceeds of a sale against various assets in various jurisdictions.

In an international divestiture, a final question would be to ask if, and how, the value of a transaction can be realized. Repatriation of proceeds may be an issue, and there may be additional transaction costs or taxes on dividends or other payments to the parent. International deals may enable flexibility in allocating purchase price among assets.

In some cases, tax implications will necessitate adjustments to an existing

deal. In others, tax implications may lead a company to significantly alter not only the form of the divestiture but also the assets to be sold or transferred. Some sellers may elect to enact certain changes in existing structures and assumptions well before the deal's anticipated closing to drive maximum shareholder value. Tax perspectives are needed early on to help managers make informed decisions.

## Distressed market divestiture

In today's economic environment, a deal can live or die on its tax implications. Some companies today are considering a variety of alternative structures featuring favorable tax aspects, including so-called tax-free deals.

Tax-free or alternative structures are not divestitures in the strictest sense. In practice, these are often reorganizations, partnerships or joint ventures without a clear buyer or seller. Often, these deals exchange assets or move assets to new

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ownership structures. Where financing is scarce, alternative transaction structures can help companies achieve divestiture goals. Among the most useful:

- ▶ **Structures that use equity as a currency** – These are reorganizations in which the US tax code allows companies to transfer assets or shares in a tax-free manner, so long as the “seller” takes back equity of the acquired company.
- ▶ **“Like kind” exchanges or “asset swaps”** – A company may be able to exchange its unwanted assets with the unwanted assets of another company. To be tax free, a critical element of such Code Section 1031 exchanges is that the assets be of a similar nature. In practice, equivalent value may be difficult to prove.
- ▶ **Joint ventures (JVs)** – Some companies use JV structures to achieve results akin to a sale. Each partner contributes assets to the JV/partnership, and economic results are allocated in a manner that resembles a sale. The tax code’s partnership rules, specifically Subchapter K, forbid disguised sales, but the rigorous tests can likely be satisfied if each partner materially retains business or creditor risk.

- ▶ **Tax-free spinoffs** – In the recent past, companies would spin off a division or subsidiary, loading the new entity with debt in exchange for cash. In today’s credit crunch, spinoffs are a means of disposing of assets in a tax-free manner. Existing shareholders obtain shares in the new entity. Companies may shift existing debt from the parent company to the new entity – with certain limits.

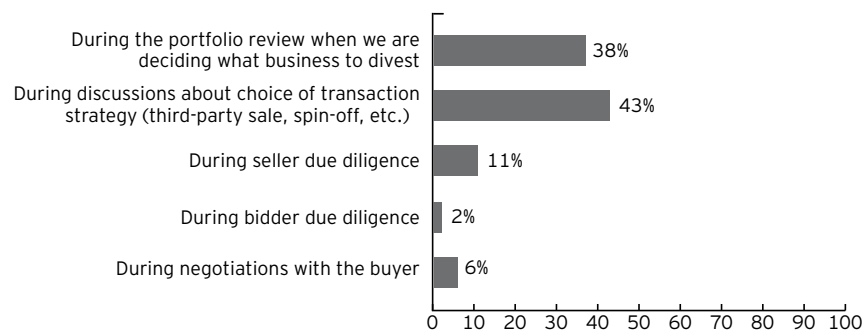
The Reverse Morris Trust (RMT) is a classic spinoff structure where the newly formed entity is merged with yet another entity – a company that is at least 50% owned by shareholders in the original parent company. Essentially, the firm is able to transfer its assets, although the parent’s owners continue to be significant or majority owners. ▼

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Consult your internal tax team early

At what stage does your company consult its internal tax team?



Source: Observations from a recent EY/Economist Intelligence Unit global divestiture survey of 360 senior vice presidents and C-suite executives from companies with revenues of more than US\$1 billion.



## Knowing the numbers

Companies exploring divestiture/monetization opportunities, understanding tax consequences and planning for the transactions generally comes down to the “numbers”:

- ▶ The tax basis of the assets and stock
- ▶ Allocation of purchase price
- ▶ Tax attributes that can be monetized (e.g., NOLs, credits, incentives)
- ▶ Modeling of cash taxes on disposition (both US and non-US divestitures) and impact on seller’s ongoing effective tax rate
- ▶ Carve-out tax provisions
- ▶ Effective tax rate for target business
- ▶ Taxes (state, local taxes and transfer taxes)

By being prepared, a seller can:

- ▶ Begin negotiations with buyer by explaining structure of the deal that maximizes seller tax benefits (e.g., deferral strategy, retention of tax attributes)
- ▶ Determine parts of seller’s existing tax structure that could be of value (or enhanced) to buyer and could be replicated for buyer (e.g., supply chain structures)
- ▶ Understand and highlight the tax consequences and benefits of alternative structures to buyer (e.g., will buyer receive amortization/depreciation deduction for purchase price)
- ▶ Negotiate non-income tax items, such as which party will finance value-added tax (VAT) in the purchase
- ▶ Know the most tax beneficial allocation of purchase price between jurisdictions or between assets and stock – assisting the seller in limiting cash taxes on the disposition and in avoiding cash being trapped in unfavorable foreign jurisdictions post-transaction

Failing to understand the numbers and the resulting tax consequences to the seller and buyer puts the seller at a disadvantage in negotiations and can result in lost value in the deal.

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