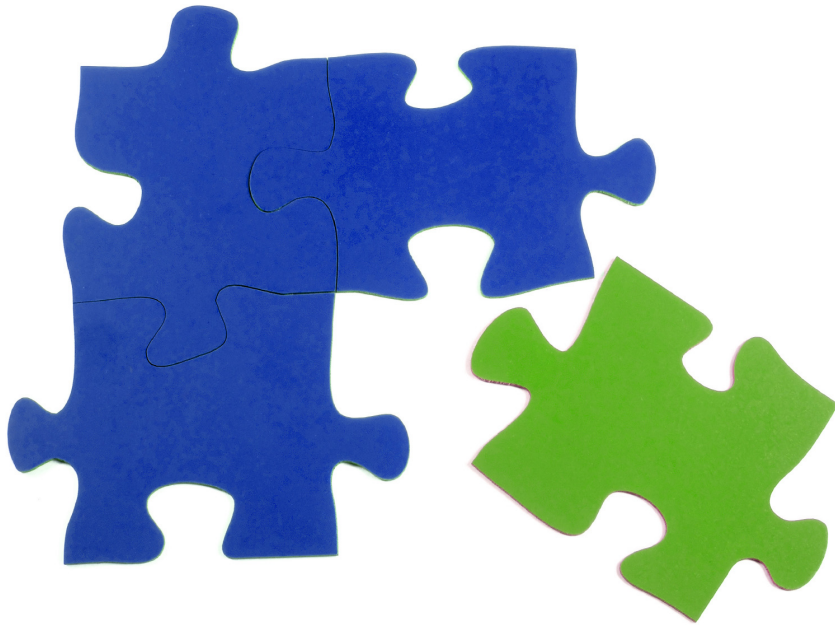


**Deloitte.**



Carve-out  
financial statements  
Tax considerations  
and complexities

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

Divestitures — the selling off of a division, unit, product line, plant, pool of assets, or other part of a company — have long been a part of the merger and acquisition equation. As more companies refocus on their core strategies to sustain future growth, many are finding the divestiture component of transactions has grown in size and complexity. Determining the tax provision information (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.

Deloitte hosted a Dbriefs webcast on October 20, 2008, to discuss tax issues arising from a divestiture, including those related to legal entity structure, allocation of temporary differences, and tax-sharing agreements, as well as tax filing, tax provision, and documentation considerations. More than 2,100 participants joined to learn how to address tax-related divestiture complications and to share their own views through responses to polling questions. Please see “Tax executives’ views” at the end of this report for more information.

## The divestiture process and key financial statement issues

Divestitures can be divided into four phases, as depicted in the exhibit on the following page. The accounting and tax functions should play a key role throughout, but their involvement in the early and late stages of 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 for performing a carve-out. Companies may look to the Securities and Exchange Commission (SEC) guidance and industry-specific

sources, but ultimately they must exercise judgment with respect to issues, such as basis presentations and cost allocations. This can be challenging when the operation to be divested has been embedded within a broader organization, and now the parties must account for it as if it were a separate operation.

Divesting organizations typically have two approaches for preparing financial statements:

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

While the SEC prefers the former, sufficient information does not always exist to support this approach. In any event, public companies are generally required to obtain permission from the SEC staff in order to utilize 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 to this process if involved at the earliest stages.

While the carve-out may represent an entire segment or division of a larger group, the accounting and financial reporting data associated with this operation may roll up in a manner that is different than the presentation of information on tax returns. It is beneficial, therefore, to look at an organization chart of all entities within the larger group to identify which entities have operations that roll up into the division or segment to be carved out. This exercise helps tax professionals determine the tax information that exists within these entities and the best manner for gathering information.

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**Four stages of the divestiture process**

Pre-sale planning	Sale strategy	Buyer selection and due diligence	Closing the transaction
<p>The time to identify potential tax, accounting, labor, operational, and system issues is before going to market. Understanding the issues and anticipating key concerns up front eliminates stops and starts during the sale process.</p>	<p>Analyzing the issues of each business from both operational and financial perspectives generates best potential value outcomes.</p>	<p>Leverage knowledge and understanding of applicable issues to assist in maximizing the success of negotiations and the selection of the optimal buyer.</p>	<p>Tax and legal counsel need to determine and negotiate the preferred structure. Evaluate need for, and assist in, drafting transition service agreements. Facilitate prompt closure and resolution of issues.</p>
<ul style="list-style-type: none"> <li>• Opportunity to find deal issues before they are raised by buyers.</li> <li>• Set the framework for tax and accounting structure.</li> <li>• Identify carve-out and integration risks.</li> <li>• Start the process of data collection.</li> </ul>	<ul style="list-style-type: none"> <li>• Gather information for data room. Assess appropriate information to provide to buyers.</li> <li>• Tailor memoranda and presentations to specific buyer groups.</li> <li>• Plan for de-integration of shared services and processes.</li> </ul>	<ul style="list-style-type: none"> <li>• Critically evaluate potential buyer’s interest. Separate the serious buyers from the “tire kickers.”</li> <li>• Establish a negotiating framework for transition.</li> <li>• Provide a systematic approach to responding to buyer inquiries.</li> </ul>	<ul style="list-style-type: none"> <li>• Resolution of final issues.</li> <li>• Minimize representation and warranties by building a bridge to due diligence.</li> <li>• Quantify the impact of ongoing transition issues.</li> <li>• Day 1 readiness execution.</li> </ul>

Legal entities may include some assets that should be carved out and some that should stay behind. Identifying these assets early enables the organization to consider how specific deferred-tax-related items will be allocated among the carved-out operations and the remaining operations. Examining the legal entity chart also can help identify particular jurisdictions — both state and foreign — that may be involved in the carve-out financial statements. These jurisdictions may affect statutory tax rates and applicable tax laws. Finally, it is important to consider the funding of the federal, state, and foreign tax liabilities, as this may affect presentation of financial statements.

### Scope and materiality

The 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, it is possible that the testing applied to those operations during the previous annual audit processes was less rigorous than what would be required for purposes of a stand-alone audit; thus, scope and materiality may become an issue. Consequently, the company may need to:

- Establish an inventory of deferred tax items that tracks assets and liabilities over time.
- Consider whether it requires a valuation allowance to offset deferred tax assets for the carved-out operation.
- Determine whether it is necessary to establish a tax reserve or FIN 48 liability for the stand-alone company.
- Identify the records that exist and whether those must be augmented in order to support the carved-out financial statement.

### Deferred taxes

The opening balance sheet provides a starting point for addressing deferred taxes. As such, it is important to initiate discussions with the external auditor up front to determine the most appropriate approach:

- A top-down approach, which utilizes previously tested and reported balances or
- A bottom-up approach, under which the new deferred balance inventory is created and then reviewed by the external auditor.

In some situations, it may be easy to identify the deferred tax assets and liabilities that would be reported on the carve-out statements. In situations where deferred tax items may not be identifiable, the company must allocate these deferred items based on a methodology, such as the percentage of assets to be carved out over the percentage of total assets.

Companies may have the benefit of utilizing the finalized temporary differences appearing on the filed tax returns when building the inventory of deferred tax assets and liabilities at a particular year-end. Because tax returns have been prepared, the company might use actual return amounts instead of estimates, and timing differences might tie back to consolidated or pro forma tax returns. This may result in deferred assets and liabilities that are different than what was previously recorded for the carved-out operations at prior-year provision time, due to tax return true-ups that are pushed back to the appropriate periods. Companies will need to work with their external auditors to determine the best approach for dealing with this situation.

The carved-out financial statement should include the inventory of deferred items that are reflective of the specific tax attributes associated with the carved-out operations. The parties may not have determined whether the purchaser will acquire assets or stock during preparations for the divestiture. Under either scenario, the financial statement should reflect net operating losses (NOLs) and other attributes that are attributed to the carved-out operations. Further, the tax footnote should include disclosures related to NOLs either produced or utilized by the carve-out operations, as well as the nature of those NOLs and whether certain credits or attributes will be allocated to the carve-out operations.

The company should treat valuation allowances as it would other ASC 740\* items; that is, it would determine whether future utilization of deferred tax assets and carryforward attributes is more likely than not and, if not, it would allocate the valuation allowance ratably between the current and noncurrent deferred tax assets. Typically, the valuation allowance determinations will require scheduling exercises. In addition, care should be taken to assess the appropriate level of valuation allowance when dealing with temporary differences associated with indefinite-lived intangible assets (as such deferred items cannot generally be scheduled out). These valuation allowances should not take hindsight into account when making a more likely than not determination of realizability. Therefore, the valuation allowances should incorporate the best information that was available as of a given historical year-end.

### Tax effect of accounting push-down adjustments

Certain accounting adjustments, such as corporate overhead and various reserve balances, may need to be pushed down to the carved-out operations in order to reflect a stand-alone company.

These adjustments often require significant thought and coordination on the part of the accounting and tax functions, as they may influence the effective tax rate calculation or the deferred tax inventory. It will be necessary to consider the tax impact of each adjustment separately in order to determine the appropriate tax treatment. For example:

- Adjustments such as meal and entertainment expenses represent permanent differences and must be reflected in the rate reconciliation.
- Some adjustments, such as those that impact reserve balances or intangibles, may give rise to timing differences.

### Consolidated tax push-down adjustments

In addition to the push-down of certain accounting adjustments to reflect the stand-alone nature of the carved-out operations, the same will typically be done with certain tax-related adjustments, which may include:

- Section 199 deductions
- Charitable contribution carryforwards
- Research and development credits
- Foreign tax credits
- Equity compensation arrangements, including options and restricted stock units
- Other

### Taxes payable balance

As a result of the various accounting push-down adjustments, it is likely that the calculated amount of federal and state taxes payable is different than what previously had been booked and paid on behalf of the carved-out operations. Although the carve-out process involves updating certain financial information to present these operations on a stand-alone basis, this process should not result in any changes to previously filed tax returns. The new taxes payable balance will not be paid, creating a unique challenge when preparing multiple years of financial statements. Further complicating matters, carved-out operations are likely to be subsidiaries in larger consolidated groups where the parent entity may fund the tax liability or collect a refund. Tax-sharing agreements may be put in place to dictate whether or not cash for taxes paid and/or received is collected from, or pushed down to, the carved-out operations.

\* Editor's note: On July 1, 2009, the FASB launched the FASB Accounting Standards Codification, a structural overhaul to U.S. GAAP that changes from a standards-based model to a topically based model. The topics are organized by Accounting Standard Codification (ASC) number (e.g., ASC 740 is the number of the income tax topic) and are updated with an Accounting Standards Update (ASU). ASUs will replace accounting changes that historically were issued as FASB Statements, FASB Interpretations (FINs), FASB Staff Positions (FSPs), or other types of FASB standards. The Codification is the single source of nongovernmental authoritative U.S. GAAP for interim and annual periods ending after September 15, 2009. At that time, it supersedes all authoritative literature in Levels A–D of the U.S. GAAP hierarchy.

How should companies reflect taxes payable or receivable when no cash tax payments are made or received? There are generally two approaches seen in practice:

- The payable or receivable balance will continue to build year over year. This may not reflect what a potential buyer can expect to pay or receive related to taxes — for example, if the adjustments substantially increase taxable income each year.
- The balance will be settled each year through an equity adjustment or an intercompany account. Under this approach, the current-year payable reflected on the balance sheet should closely mirror the actual current-year tax provision expense, reflecting what a buyer can expect to pay or receive on an annual basis.

Regardless of the approach, the financial statements should clearly explain the methodology chosen.

### State tax considerations

Companies with multistate operations will have various considerations in a divestiture — for example, if the carved-out operations:

- Operate in certain states separate from the consolidated group.
- Have a portion of income taxed in a state where they do not operate due to a unitary filing requirement.
- Operate by themselves in a state that requires a unitary filing, thus subjecting the consolidated group's income to tax in that particular jurisdiction.

Depending on the states in which the carved-out operations function, tax rates may be different than those typically applied to the consolidated group. The apportionment for the carved-out operations is likely to be different and may need to be recalculated on a stand-alone basis to determine a reasonable state tax rate. To the extent the carved-out operations have nexus from their activities as opposed to having income apportioned from the consolidated group, the applicable tax rate may be

affected. Finally, the company will need to consider unitary versus separate company filings that may cause a shift in state tax rates. The carved-out operations may find it challenging to gather supporting information in instances where they are much smaller than the consolidated group and state taxes typically have been booked at one standard rate. This may require a review of past state tax returns filed on behalf of the carved-out operations to gain a better understanding of where to apportion income.

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## It will be important to identify whether the carved-out operations will be presented pursuant to branch accounting rules or foreign subsidiary accounting rules.

### International tax considerations

There are many potential international tax implications. Depending on the jurisdictions in which the carved-out operations function, tax rates may be different than those typically applied due to:

- The size of the carved-out operations in a particular jurisdiction.
- 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 as a result of the use of carve-out financials.

Consideration should be given to whether there is a need to re-evaluate an APB 23 assertion and whether or not the assertion changes because of the carve-out. Although we

would not expect an assertion to change, qualified advisers should be consulted.

Further consideration should also be given up front to the form of the presentation of the carved-out operations. From an international perspective, it will be important to identify whether the carved-out operations will be presented pursuant to branch accounting rules or foreign subsidiary accounting rules.

### Tax contingencies and FIN 48

The consolidated group may have tax reserves or FIN 48 liabilities, some of which relate to the carved-out operations. In this case, it will be necessary to consider the company's consolidated reserve balance and determine a reasonable approach — through identification or allocation — for assessing how much of the overall liability is attributable to the carved-out operation.

On December 30, 2008, the Financial Accounting Standards Board (FASB) issued FSP FIN 48-3, which defers FIN 48 for certain nonpublic entities for an additional one year (to be effective for fiscal years beginning after 12/15/2008) and requires all entities deferring FIN 48 to disclose that fact and their accounting policy for evaluating uncertain tax positions in the footnotes to the financial statements. A second FSP will address the decision to exempt nonpublic entities from the disclosure requirements under paragraphs 21(a) and 21(b) and provide implementation guidance for passthrough entities. For the time being, nonpublic entities involved in carve-outs will continue to report their tax uncertainties under their existing policy.

### Tax footnote disclosures

Unless the 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 and includes:

- An effective tax rate reconciliation.
- A summary of the current and deferred tax provision.
- A schedule detailing the deferred tax assets and liabilities.
- If necessary, a FIN 48 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:

- Comment on the legal structure and how the operations themselves are treated for tax purposes — i.e., separate versus consolidated group.
- Push-down of tax attributes so that the buyer may begin to consider the value that it will drive from use of these attributes on a post-transaction basis.
- The methodology used for tracking the payables or receivables balance.

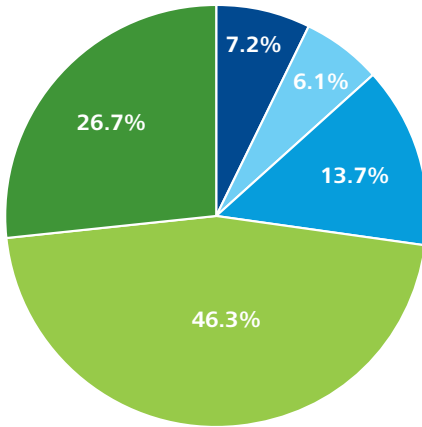
For organizations considering a divestiture, it is never too early to begin planning, initiating discussions with external auditors, and establishing the required level of collaboration between the tax and finance functions.

### Tax executives' views

Deloitte hosted a Dbriefs webcast on October 20, 2008, to discuss tax issues arising from a divestiture, including those related to legal entity structure, allocation of temporary differences, and tax-sharing agreements, as well as tax filing, tax provision, and documentation considerations. More than 2,100 participants joined to learn how to address tax-related divestiture complications and to share their own views through responses to polling questions.

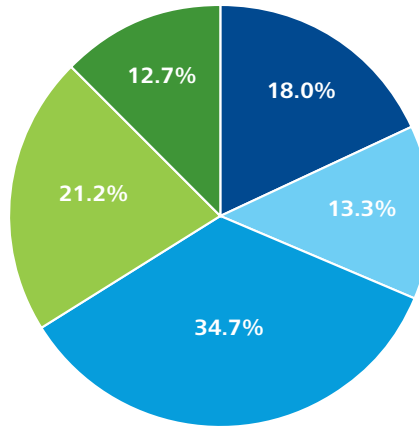
Twenty-seven percent of respondents indicated that their companies either were in the process of a divestiture or were considering one within the next year. Views on the most difficult aspect of pulling together deferred taxes in a carve-out varied from organization to organization. The most-cited difficulty, reported by approximately 35 percent of the participants, was separating deferred assets and liabilities between operations that will stay versus those that will be carved out. Difficulties in tracking tax attributes for the carved-out operations, valuation considerations without hindsight, and locating related records were also cited.

**Is your company currently involved with or considering a divestiture?**



- Yes - Expect to start in the next six months
- Yes - Expect to start in the next year
- Currently in process
- No
- Don't know/not applicable

**What do you think would be the most difficult thing in pulling together deferred taxes in a carve-out?**

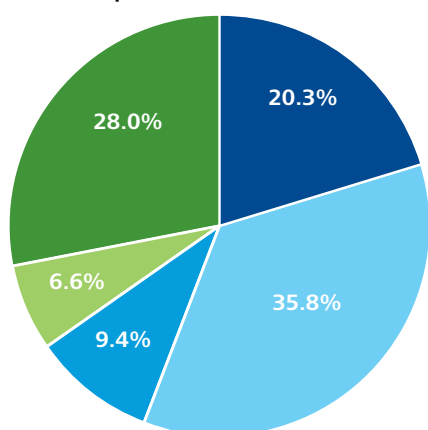


- Valuation considerations without hindsight
- Locating related records
- Separating deferred assets and liabilities between operations that will stay versus those that will be carved out
- Tracking tax attributes for the carved-out operations
- Not applicable

Approximately one-fifth of the respondents indicated that their company uses one state rate for the entire company when determining what effective state tax rate to apply for purposes of the tax provision. More than one-third reported that each legal entity applies a rate that is consistent with that entity's apportionment.

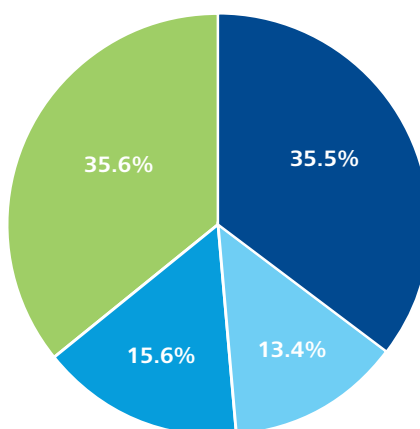
About half of the participants indicated that their company would use carve-out statements in the future for a potential sale of a business segment or spin-off.

**How does your company determine the effective state tax rate to apply for purposes of the tax provision?**



- One state rate is used for the entire company
- Each legal entity applies a rate that is consistent with that entity's apportionment
- Each business segment applies a rate consistent with that business segment's apportionment
- Other
- Don't know/not applicable

**How do you see your company using carve-out statements in the future?**



- A potential sale of a business segment
- A potential spin-off
- Internal business segment benchmarking
- Not applicable

**Additional resources**

For additional updates on income tax accounting matters, please visit <http://www.deloitte.com/us/finreportingtaxes>.

Also, please note Deloitte's Merger & Acquisition Services professionals have access to a wide array of accounting, tax, financial advisory, and consulting services to help serve our clients.

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