

Post-merger integration (PMI) from tax perspective

The Dbriefs Corporate Income Tax series

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8 December 2022

Agenda

- Identifying tax synergies by participating in cross-functional integration team or PMO/IMO
- Tax planning with respect to any planned divestitures including carve-out financials
- Evaluating IP, value-chain and supply-chain planning opportunities
- Evaluating transfer pricing requirements and documentation; and
- Simplification of legal entity structure to align with the integrated business model, update tax efficient profile, and enable cost savings
- Questions and answers

Polling question 1

What has been your involvement in the Post Merger Integrations?

- Fully involved with other functions in PMI process
- Provided input on tax matters only but input but not part of overall PMI team
- Not involved in any PMI process
- Don't know/not applicable

Introduction – tax-aligned business integration

Getting the tax department “integrated with the integration”

- Establishing the tax department’s participation in the integration program
- Exploration of the tax issues and opportunities associated with the business process changes
 - Finance
 - Information technology
 - Supply chain
 - Human resources
 - Sales and marketing
 - Legal entity structure/rationalization

Tax synergies and tax planning – PMO/IMO Participation

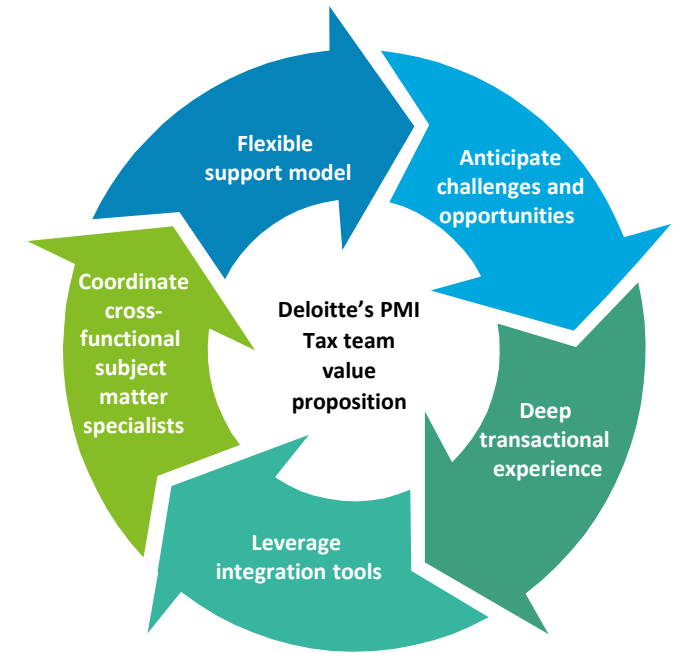
Deloitte tax integration approach



Tax has cross-functional interdependencies throughout the organization that need to be taken into account with respect to operational and Legal Entity restructurings, integrations, and separations

Tax department considerations

- Accounting for Income Taxes
- Federal, State and Local Income Taxes
- Indirect Tax
- Global ETR
- Global Transfer Pricing
- Tax Controversy
- Tax Department Operating Models
- Compensation & Benefits
- Credit and Incentives / Excise Taxes



Technical tax issues associated with the transaction

- Transaction execution, legal entity (LE) stand-up and Tax Day-1 readiness
- Tax basis analysis and computations
- Model "Next Day" rules, short-period impact to tax attributes, cash taxes and tax provisions
- Analyze and document tax treatment of transaction and finance costs
- Indirect tax cutover support
- Strategic review and harmonization of post-close tax accounting methods and policies
- Analyze employment tax impact and planning

Tax department operations and financial reporting

- Acquisition accounting support, including preparation of opening balance sheet, deferred tax balances and analysis of uncertain tax positions
- Advise on development and testing of interim tax processes to meet interim and annual financial statement requirements
- Develop plan to timely meet prospective tax regulatory and compliance requirements, including short-period reporting requirements
- Update tax department design for Day-1, interim and future state tax department (people, process and technology)

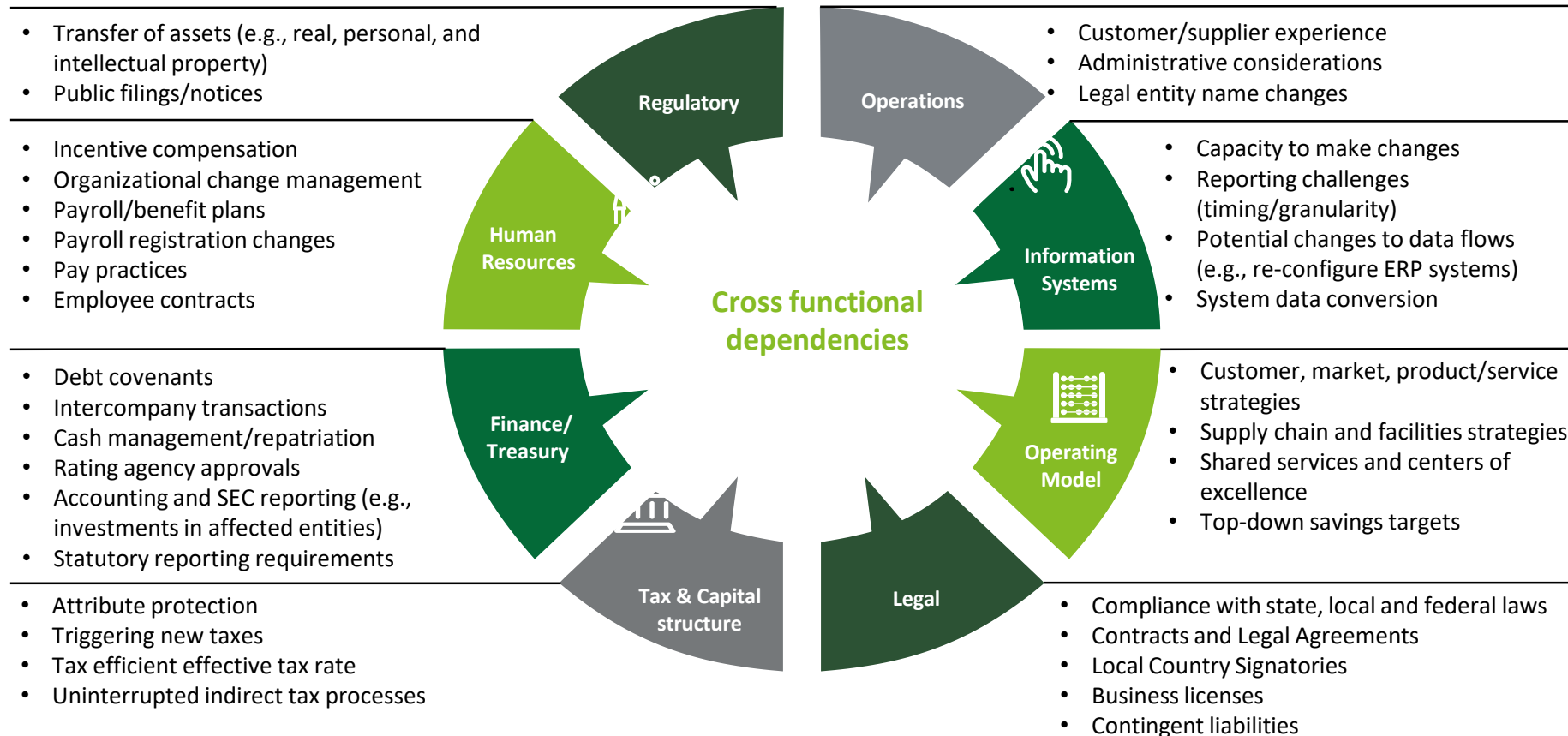
Tax considerations in business process improvements and synergy capture

- Simplify LE structure to align with the integrated business model, update tax efficient profile, and enable SG&A cost savings
- **Proactively identify tax synergies by participating in cross-functional integration team or PMO/IMO**
- Evaluate IP, value-chain and supply-chain planning opportunities
- Evaluate transfer pricing requirements and documentation
- **Tax planning with respect to any planned divestitures including carve-out financials**
- Support local credits and incentives expansion requests and preservation



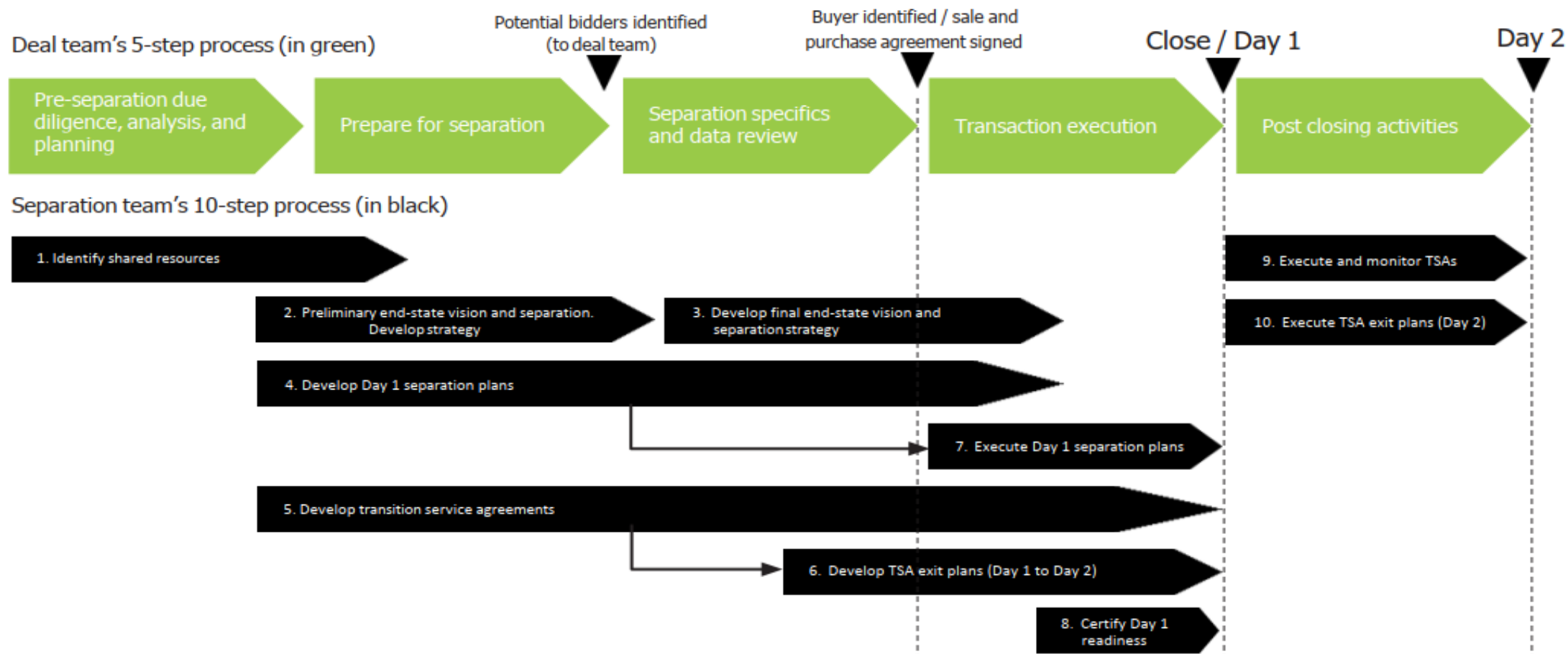
Tax integration cross-functional coordination

An effective Tax Integration involves representatives from many functions. Critical to the integration plan is the cross-functional vetting of dependencies to and from tax and alignment of tax milestones in a detailed workplan with the other functional integration plans



Tax separation cross-functional coordination

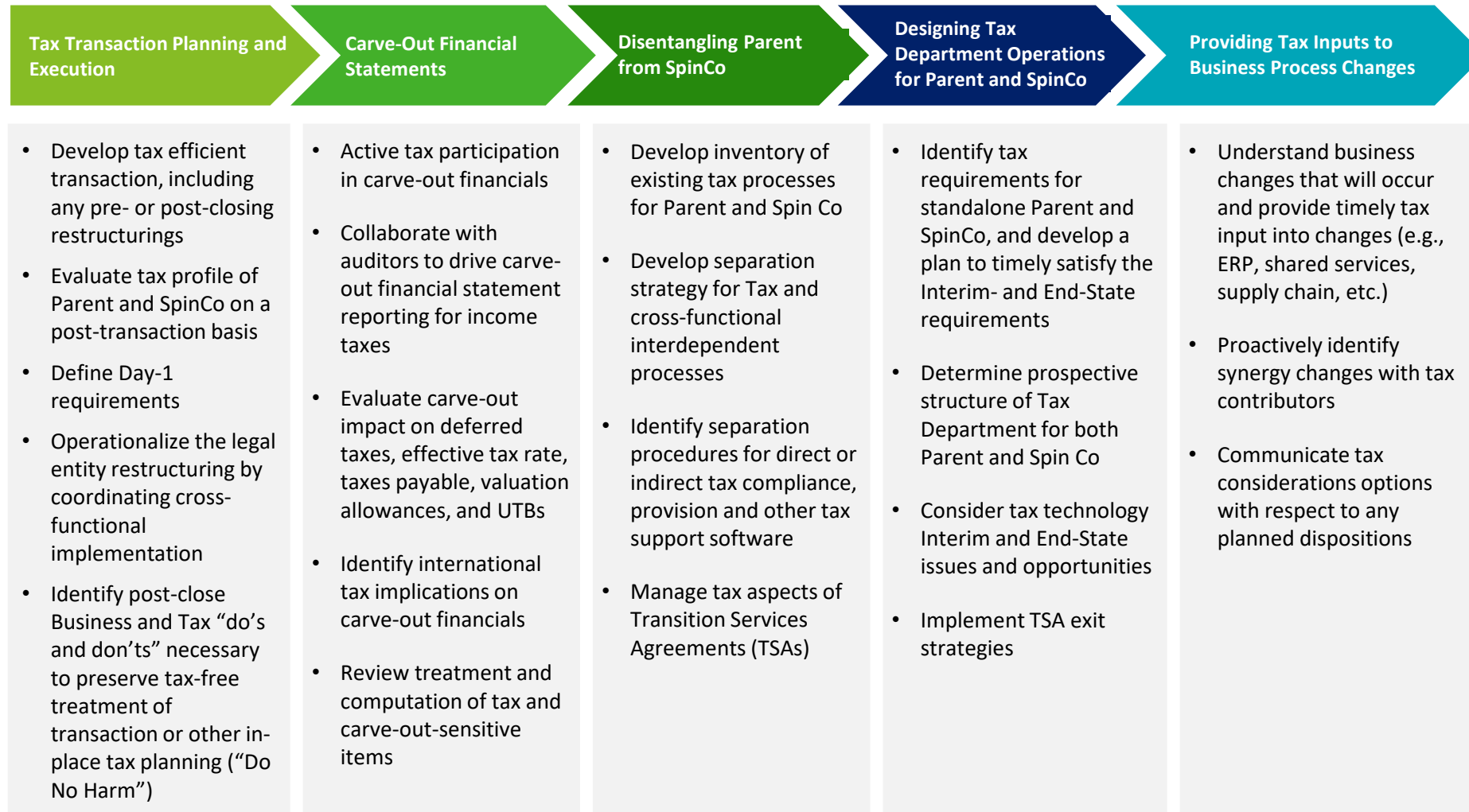
Parallel transaction and operational planning processes



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Deloitte tax separation approach

A disciplined separation approach assists with the identification and anticipation of tax issues and opportunities from both the transaction and its impact to tax department operations



Polling question 2

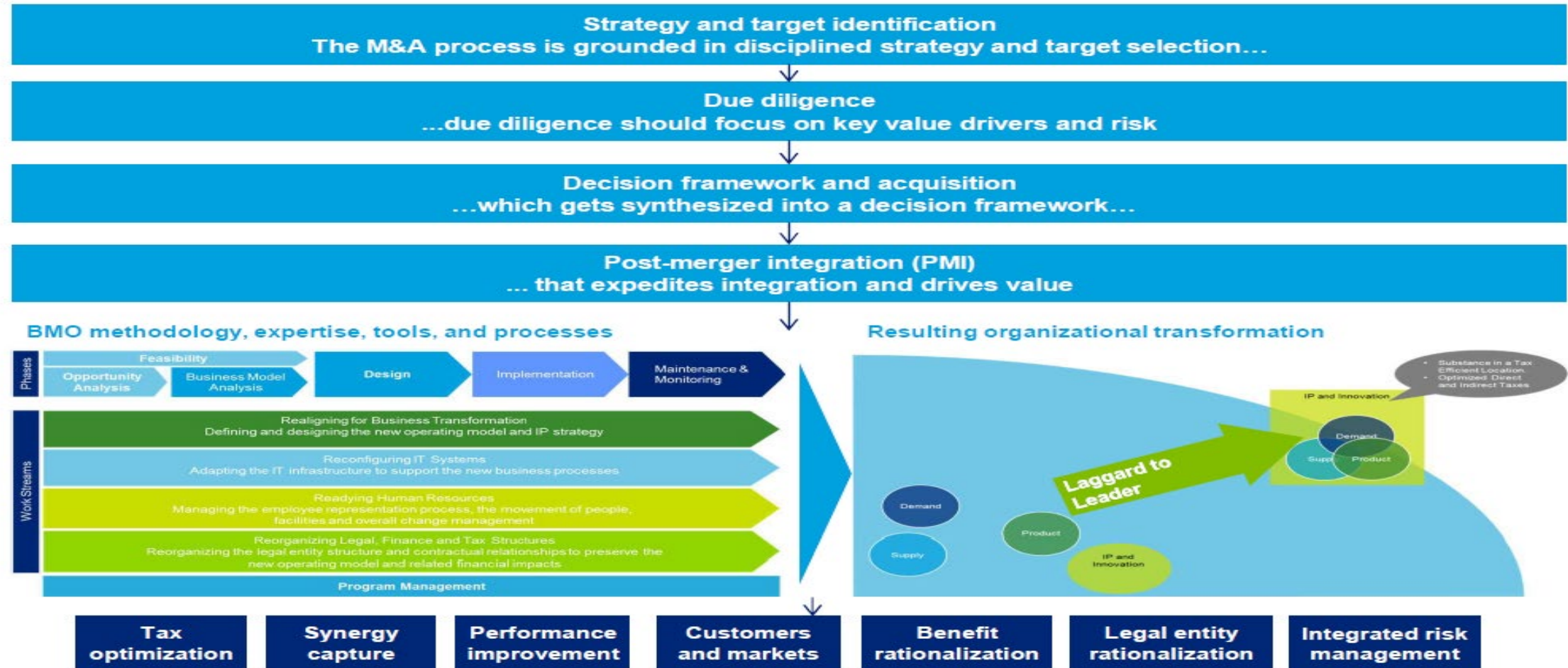
Based on your prior experience with PMO/IMO teams, in your opinion, how is tax department viewed by the other functions in regards to adding value to the process?

- Tax department viewed as adding significant value
- Tax department viewed as adding average value
- Tax department viewed as adding little to no value
- Don't know/not applicable

Evaluating IP, value-chain and supply-chain planning opportunities including transfer pricing

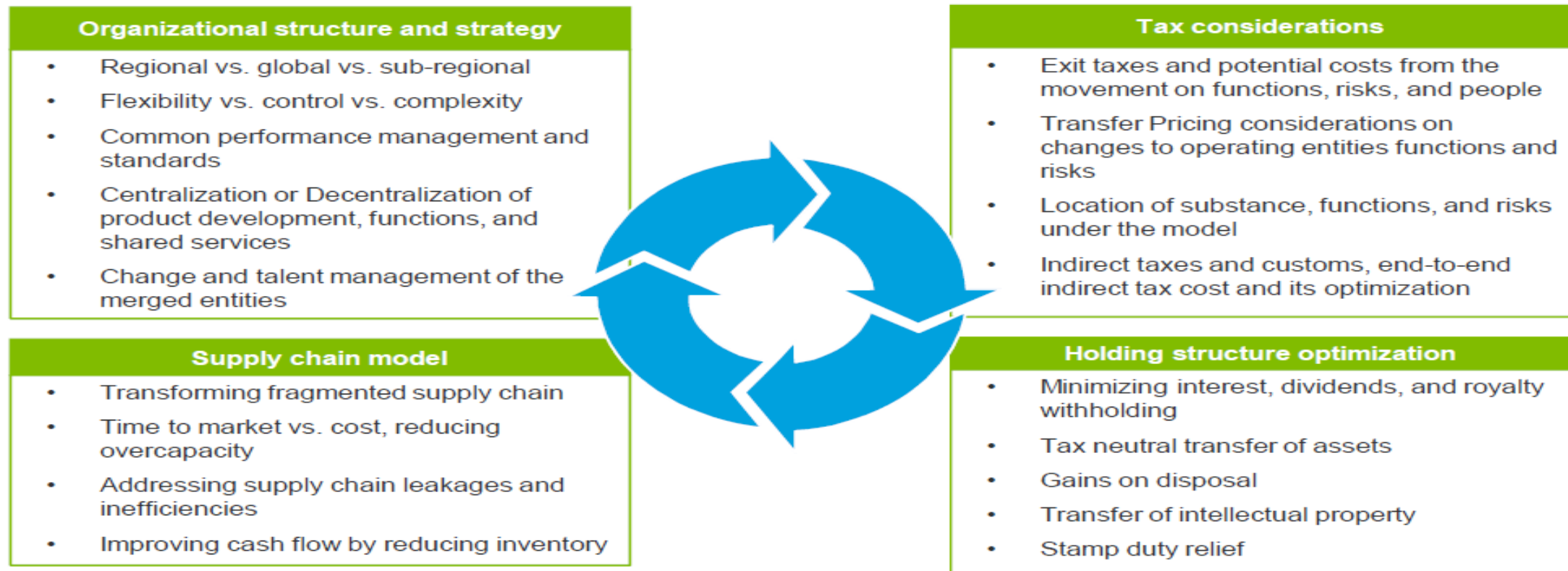
BMO in M&A life cycle

Utilizing BMO methodology and tools in an M&A life cycle greatly enhances the changes of successful integration and value enhancement



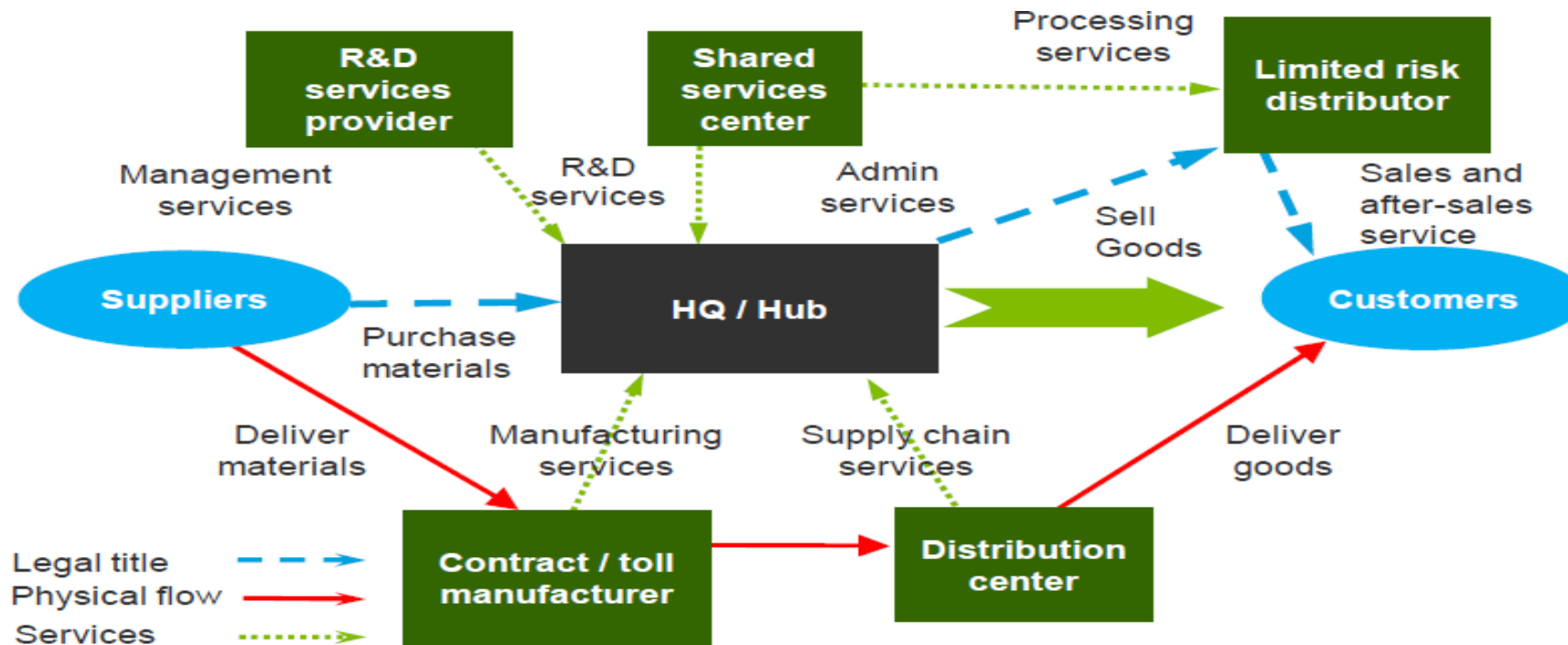
Balancing tax planning and operational integrations

- Integration of operations and structure requires careful consideration of various complex and inter related aspects in order to appropriately design a model and structure that drives tax savings and creates valuable business synergies
- If a mature and efficient operating model is used by the one of the groups, integrating the other group may be less challenging however PMI provides a good opportunity to re-examine the overall model for opportunities and risks



Post PMI – illustrative tax/supply chain model

- HQ functions
 - Manufacturing strategy, product development, innovation strategy
 - Supplier demand planning, capacity planning, inventory management logistics, and distribution planning
 - Timely management of intangibles, i.e., intellectual property (IP), unpatented technology, process know how, brands, etc.
 - Funding and ownership of future IP development
 - Monitoring and supervision



Essence of TP position

- Key profit drivers (risk, valuable IP) are placed with principal, who receives entrepreneurial return. Other entities perform routine functions (cost plus return / sales minus) or management / services fee.

PMI exercise

Key driving factors

- Reduction in group ETR
- Expansion via entering new markets
- Set-up or increase global footprints
- Focus on core activities
- Reducing the number of companies in a group
- Backward and forward integration of business
- Ease of access to capital and debt from international market
- Location of customers
- Increasing shareholder value via increased efficiency

Holding structure optimization – considerations

- Consider BMO in the earlier stage of the M&A process
- Entitlement to special tax regime in some Asia Pacific (APAC) countries
- Minimize tax by profit realignment
- Tax efficient profit repatriation and exit at risk
 - Lack of treaty protection
 - Base erosion and profit shifting (BEPS) legislation and enforcement
 - Substance requirements
 - Controlled foreign corporation (CFC) legislation
- Supply chain that provides the substance

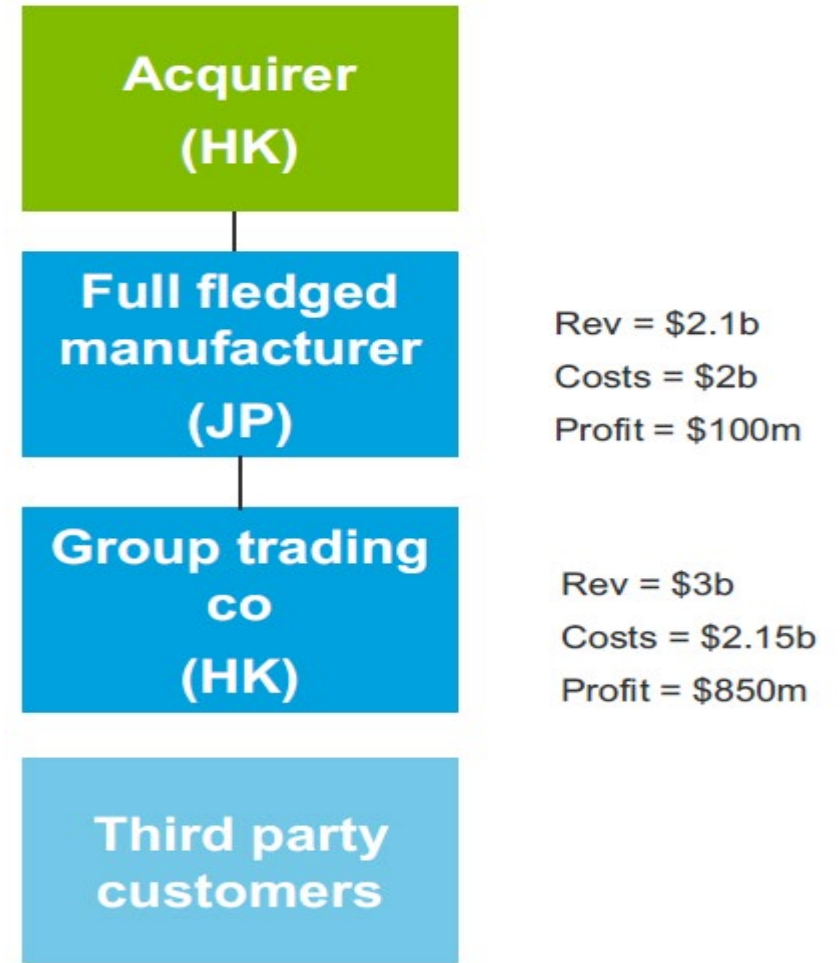
PMI – requirement and major transaction

- Transfer of business is required to meet with arm's length principle
- Valuation of business to consider both tangible and intangible assets (including human capital, marketing channels, technology, customers list, contracts, goodwill, etc., related intangibles)
- Major transactions which require detail analysis during PMI exercise includes
 - Valuation of equity/shares
 - Valuation of intangible
 - Royalty rates/license fee
 - Financing transactions
- The aforementioned transactions are frequently challenged transactions from TP perspective and need to be well analysed during integration phase

Case study 1 – tangible goods

- The **target group** is a highly profitable full fledged manufacturer and distributor of industrial equipment
- The full fledged manufacturer (in Japan) has developed and owns all IP, does all manufacturing and is responsible for managing global customer relationships (75% of business)
- Global revenue of US\$3 billion
- Group trading co (in HK) buys products from full fledged manufacturer at cost plus 5%
- Been operating like this for 10 years

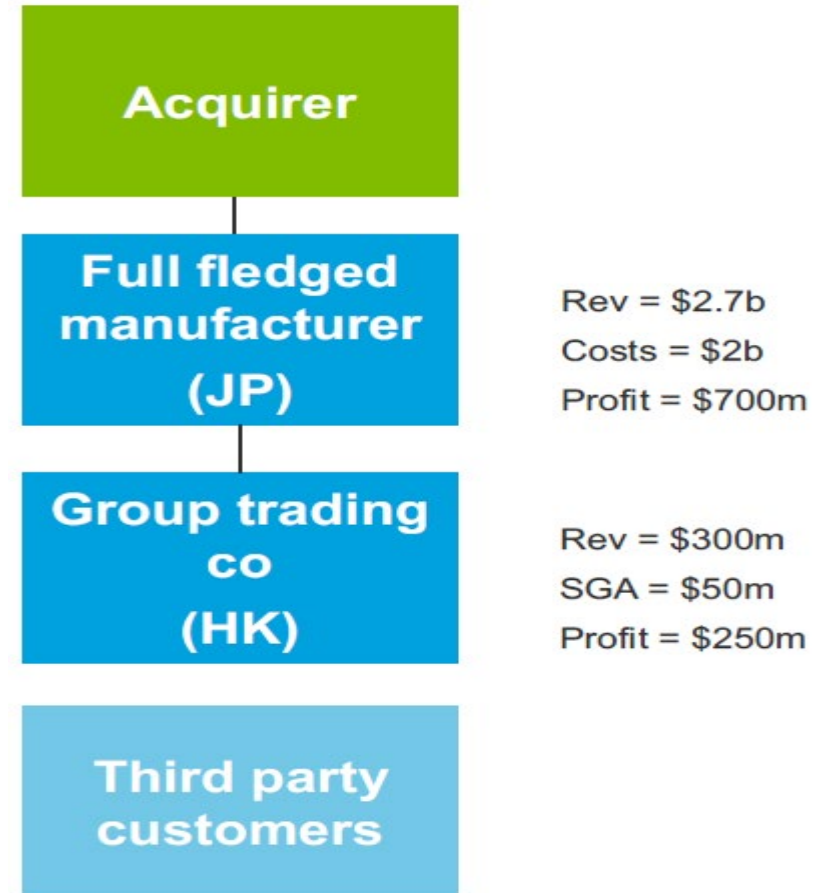
Structure pre-acquisition



Case study 1 – tangible goods (cont'd)

- Due diligence fact finding alarming
- Tax authorities in Japan may reject the model and re-characterize the transaction claiming that the trading company should earn 10% commission
- Japan profit increases by US\$600 million
- With 6 years of statute barring, the gives total income adjustment of US\$3.6 billion (excluding penalties and interest)
- Double tax treaty applies from **2012/2013**, so no MAP
- For post **2012/2013** MAP would be hard to get

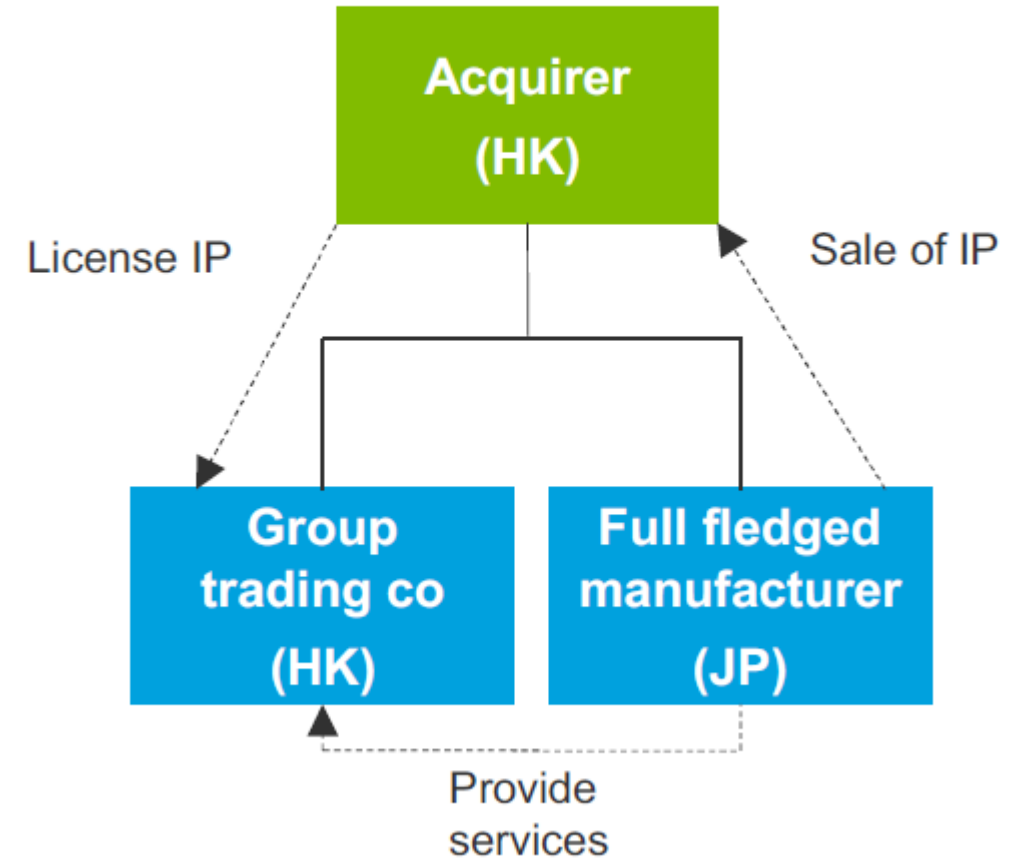
Due diligence – potential exposure



Case study 1 – tangible goods (cont'd)

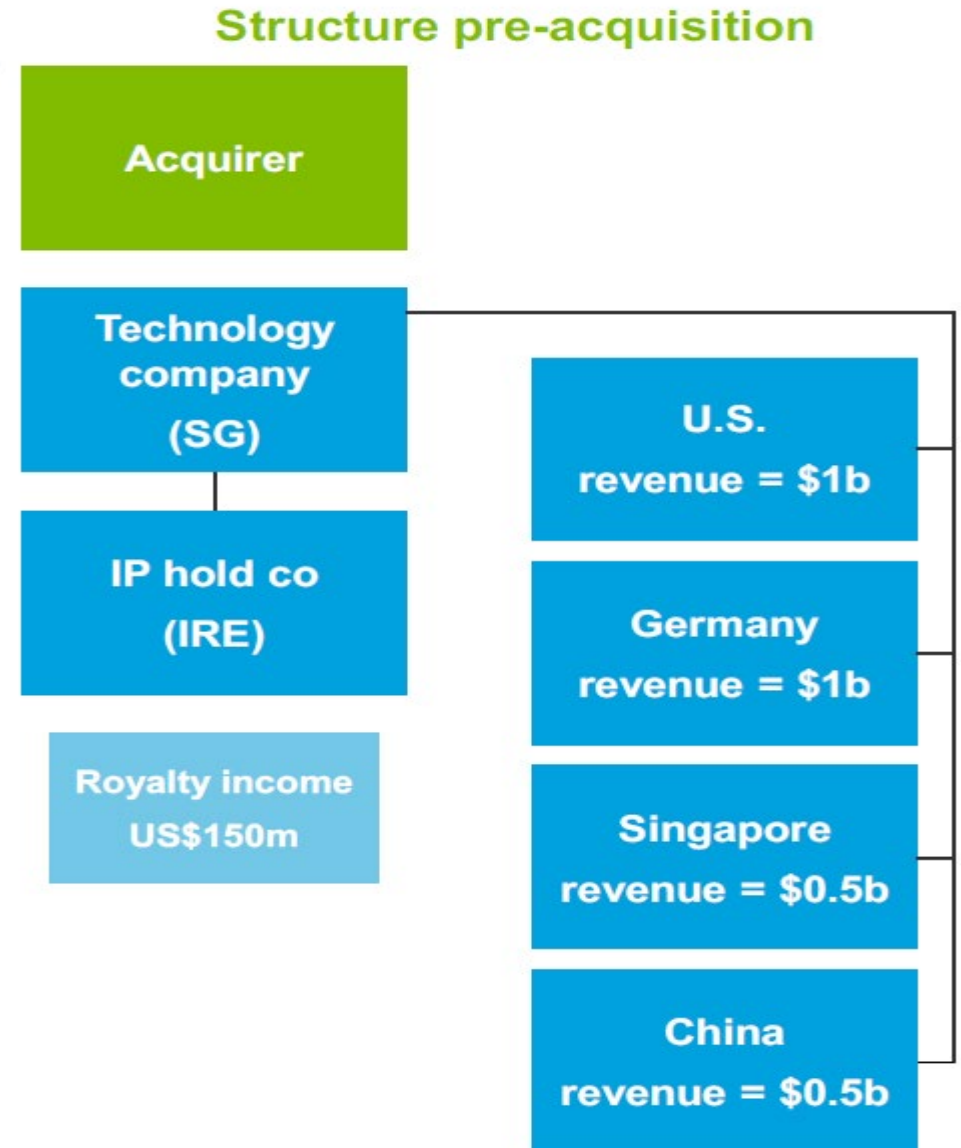
- Intangible property
 - Patents, trademarks will be purchased by the acquirer in HK
 - License IP to Group trading co
 - **Valuation of existing IP and future royalty payment needs to be examined**
- Relationship management
 - Full fledged manufacturer to provide services to Group trading co to manage products delivery
 - **Alternatively, one can look at converting full fledged manufacturer into a contract manufacturer, since IP is moved to Acquirer**
- Profitability
 - Group trading co can earn residual profit if IP owner and service provider are remunerated properly
 - Substance should be established with IP owner and group trading co to justify functions and risk

Post-acquisition optimization



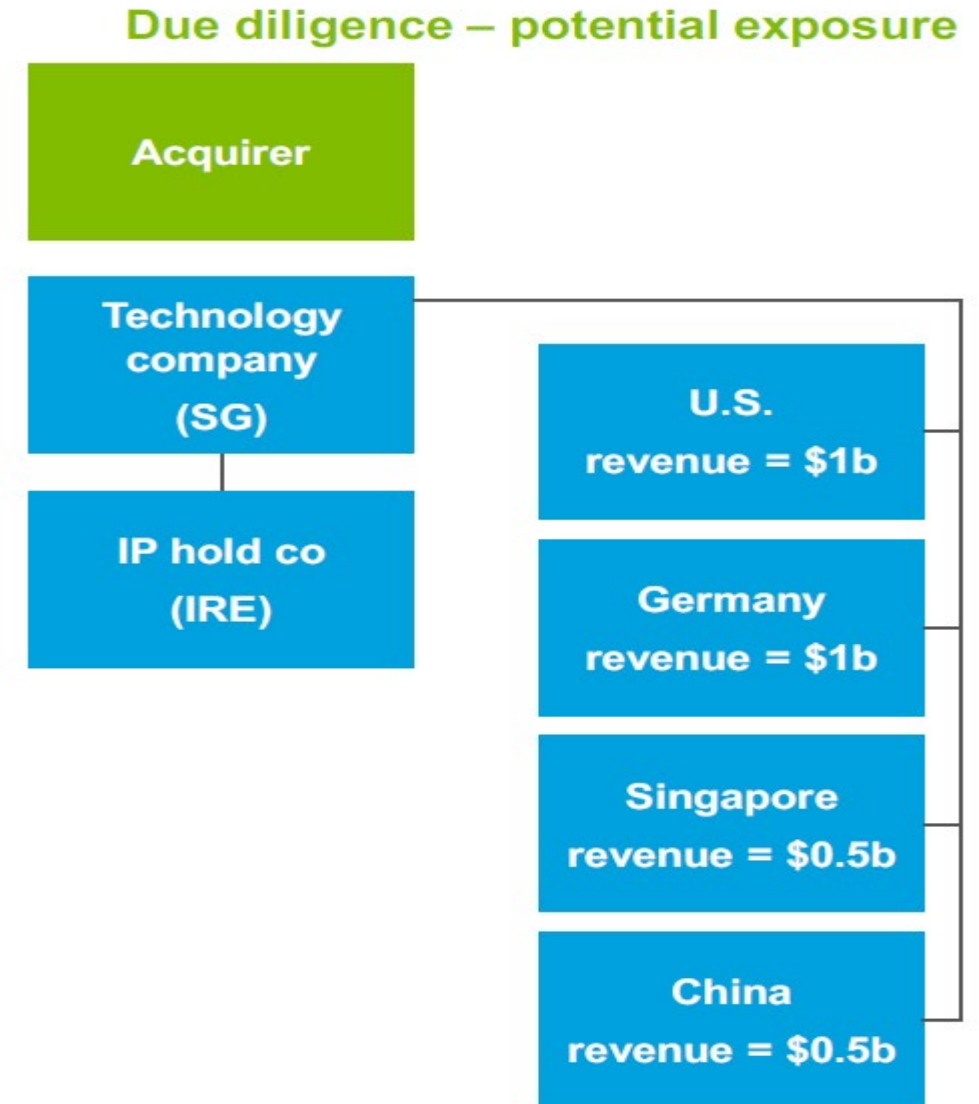
Case study 2 – intangible property

- The Singapore technology company has been built up through acquisitions over 10 years
- IP planning advice in past said to transfer IP to Ireland hold co
- IP hold charges a 5% royalty to each subsidiary
- Singapore and China provide research and development (R&D) services to IP hold co



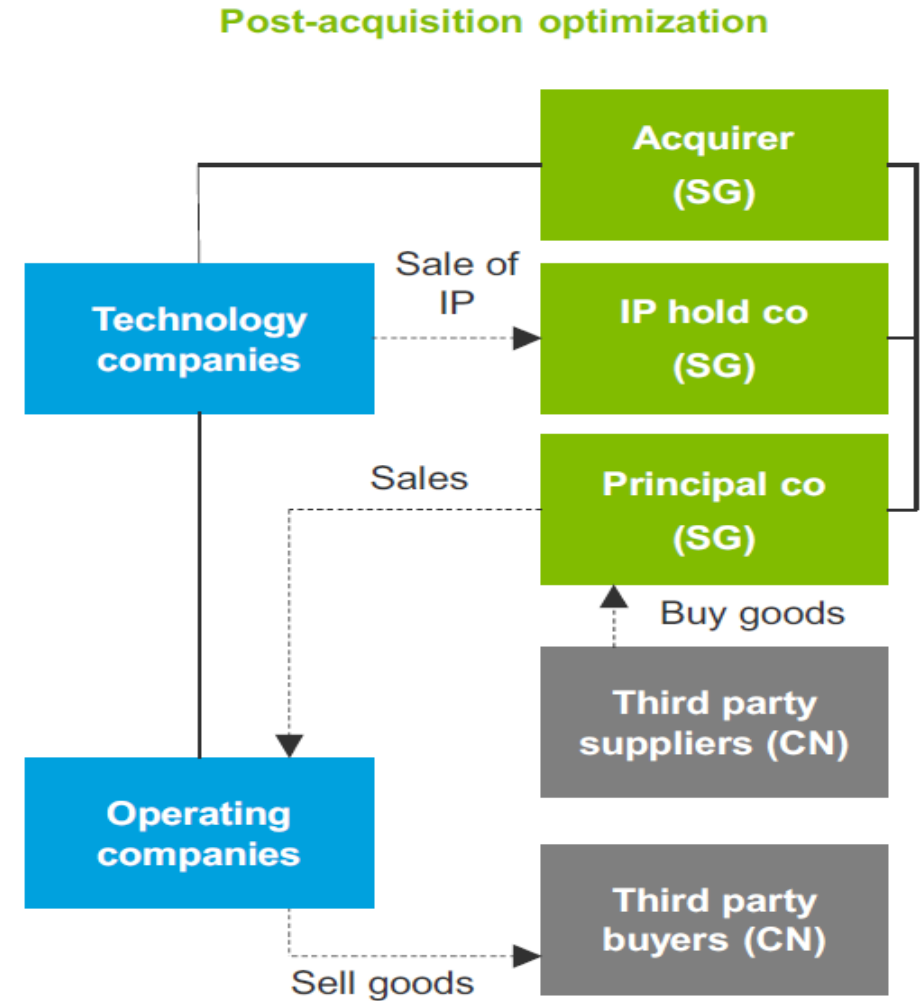
Case study 2 – intangible property (cont'd)

- Due diligence fact finding alarming
- U.S. and Germany
 - Legal agreements signed for IP
 - No compensation or buy in paid
 - Tax authorities could claim IP never actually transferred and deny royalties resulting in additional income of US\$50 million each per year
- Singapore and China
 - Contract R&D agreement in place
 - U.S. and Germany paid for 2 years
 - Unpaid in 3 of past 5 years
 - Tax authorities could claim IP is partly funded locally
 - Could deny royalty deductions or even claim royalties from group members



Case study 2 – intangible property (cont'd)

- Further investigation helps decide how to deal with material risks
- Manageable problems
 - Plan to transfer existing IP into group IP hold co
- “Too hard” problems
 - **Quarantine existing liabilities. Plan for future IP development in IP hold co**
- Tangible goods
- Use principal company with preferential tax treatment
 - Set profitability of operating companies
 - Valuation of existing IP (buy-in) and future royalty payment needs to be examined from TP perspective



Lessons from the cases

- Has the target company addressed key TP issues that can potentially give rise to significant tax liabilities?
 - Is form and substance aligned and backed by contracts
 - What are the key value drivers (IP) in the business and who are the economic owners?
 - Have all intercompany transactions been identified and paid for (e.g., guarantees, services, etc.)?
 - Has there been share issuances and have been adequate due diligence on the “valuation” of such shares?
 - What are the possible remedies available to mitigate TP related disputes?

Tax efficiency, cost savings, and other synergies

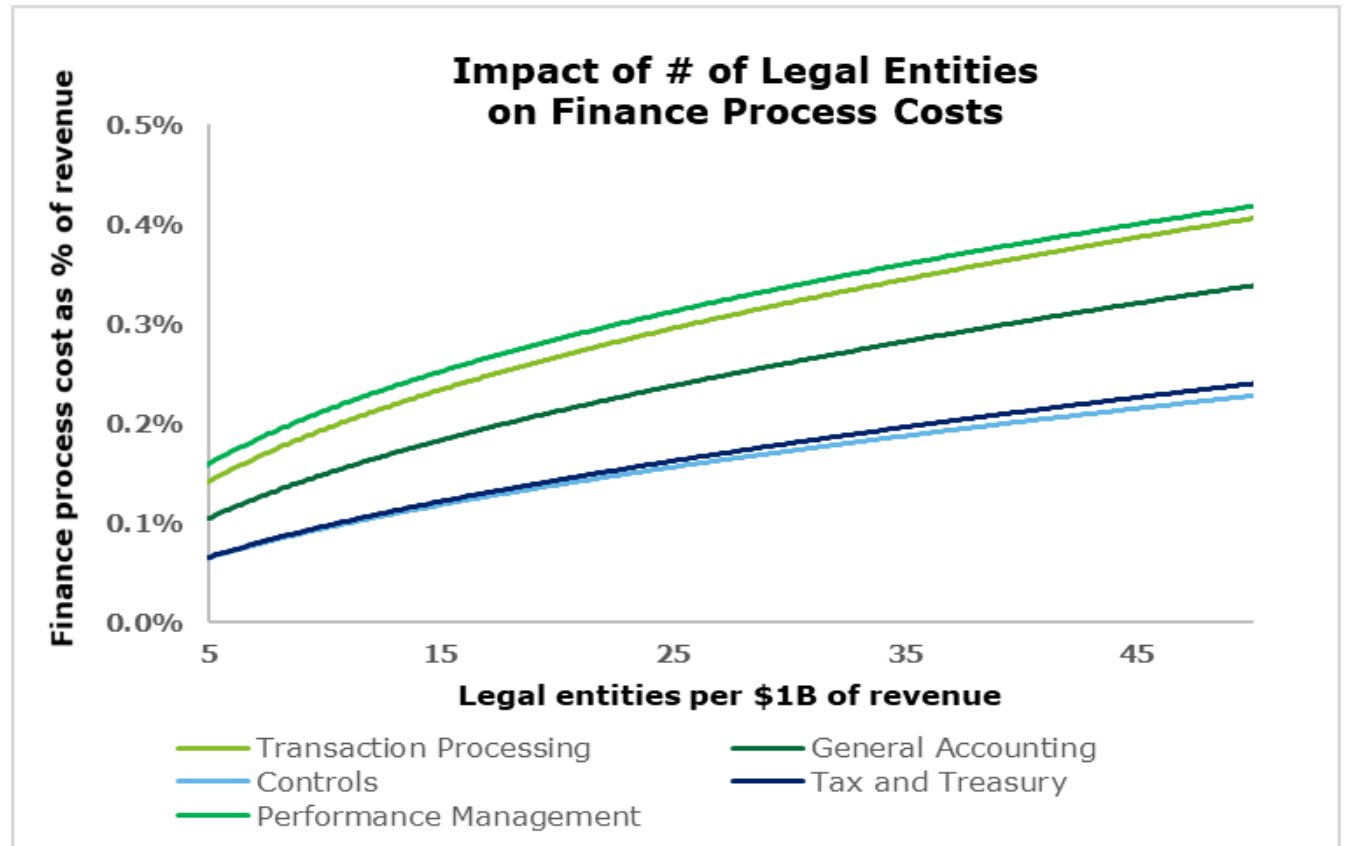
Legal entity rationalization

Benefits

Opportunities for savings are significant since legal entity complexity impacts process costs across multiple functional areas. A recent study shows the correlation between finance process cost and the number of legal entities

Study findings and implications¹

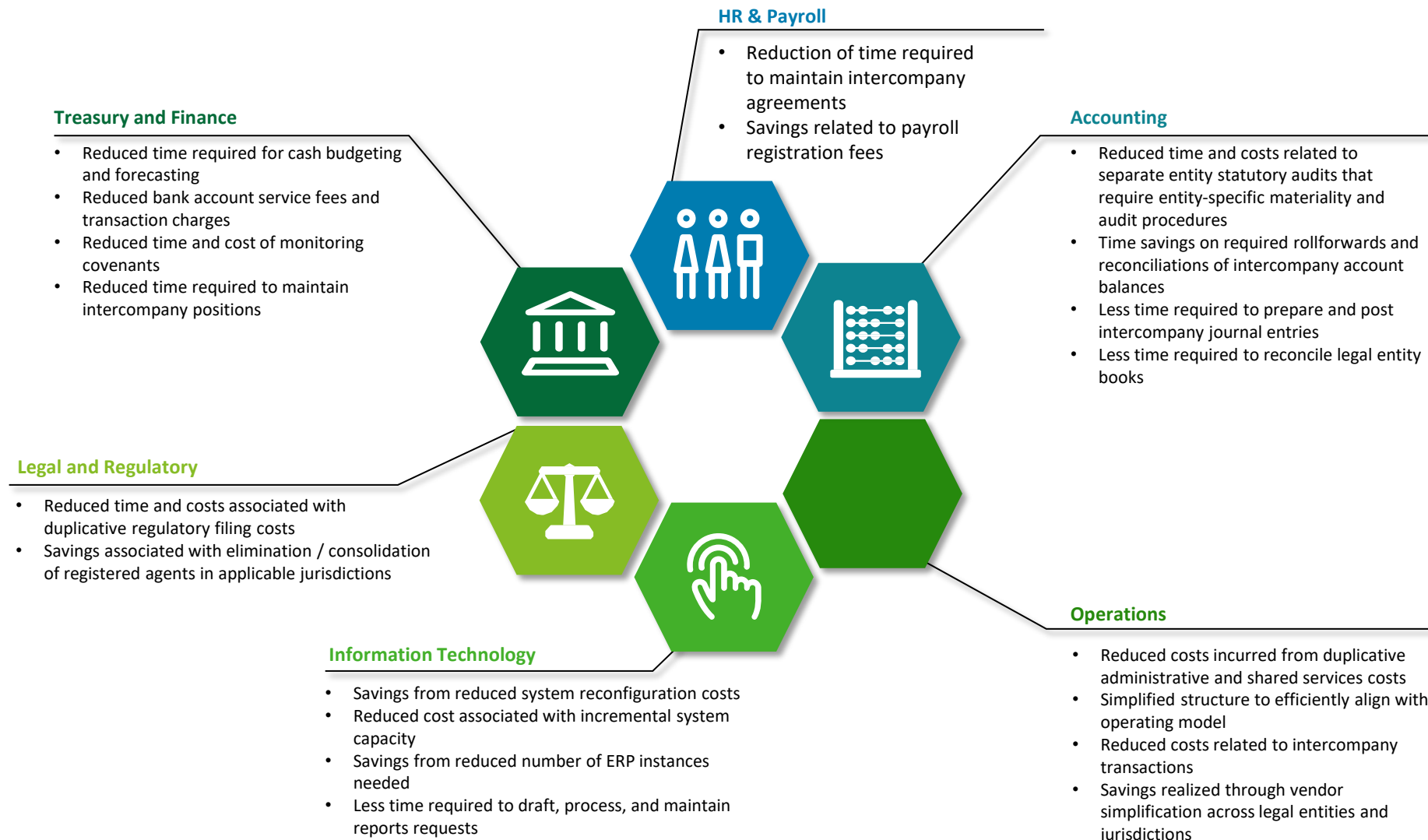
- There is a clear correlation between the number of legal entities and finance process cost
- On average, the difference in finance function cost between enterprises that have 5 legal entities per billion and enterprises that have 10 legal entities per billion in revenue is as follows
 - Transaction processing: \$548K per \$B revenue
 - Performance management: \$534K per \$B revenue
 - General accounting: \$482K per \$B revenue
 - Tax and treasury: \$357K per \$B revenue
 - Control and risk management: \$332K per \$B revenue



¹Source: Deloitte Data Services analysis of 24 enterprises conducted in 2018

Legal entity rationalization

Example cost/time savings



LER cross – functional dependencies

An effective PMO involves representatives from many functions

It is important that the eight key functions below are consistently represented as active participants throughout the scope of a Legal Entity Rationalization project so that cost savings, interdependencies, issues, and opportunities are identified and addressed in a timely manner

Sample Functional Issues

Regulatory / Compliance

- Transfer of assets (e.g., real, personal, and intellectual property)
- Public filings / notices

Operations

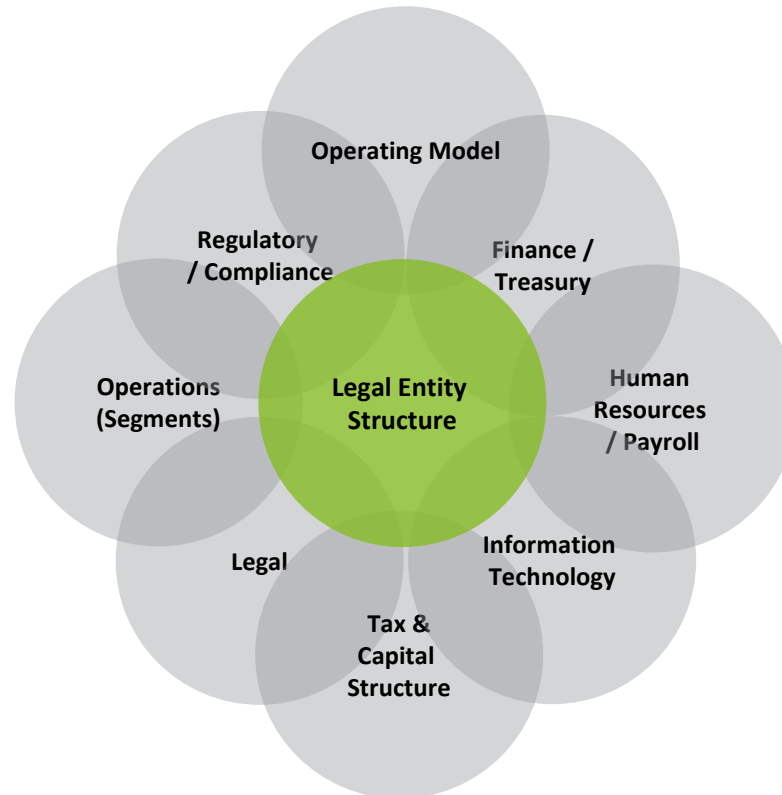
- Customer / supplier experience
- Administrative considerations
- Establishing legal presence within a geography
- Legal entity name changes

Legal

- Compliance with state, local and federal laws
- Business licenses
- Contingent liabilities

Human Resources

- Incentive compensation
- Payroll registration changes
- Employees for payroll / benefit plans
- Vendor Provision Synchronization
- Organizational change management
- Pay practices
- Employee contracts



Operating Model

- Customer, market, product / service strategies
- Supply chain and facilities strategies
- Shared services and centers of excellence
- Top-down savings targets

Finance/Treasury

- Debt covenants
- Intercompany transactions
- Cash management / repatriation
- Rating agency approvals
- Accounting and SEC reporting (e.g., investments in affected entities)

Tax & Capital Structure

- Attribute protection
- Triggering new taxes
- Tax efficient effective tax rate
- Uninterrupted indirect tax processes

Information Technology

- Capacity to make changes
- Reporting challenges (timing / granularity)
- Potential changes to data flows (e.g., re-configure ERP systems)

Case study – LER after acquisition

- **Situation**

- Consolidated Group with approximately 120 entities throughout the world in 50+ countries
- Acquired additional consolidated group with approximately 40 entities in 25+ countries
- Only 5 of the acquired entities were in new jurisdictions
- Undertook project to reduce 160 entities down to approximately 100 entities including combination of legacy entities
 - Estimated annual hard savings (stat audit, tax compliance, global audit, etc.) was \$100K per entity with additional savings in headcount, controls, treasury, etc. expected with expected completing in 1 to 2 years

- **Key Learnings**

- Tax considerations (use of NOLs, tax planning, etc.) was the easiest part
- HR related items (work councils, benefit matching, etc.) was the leading reason why combinations did not take place
- IT (financial and other systems) was a big issues in many cases
- Legal (contract transfer, supplier qualification, merger process) took longer than expected

- **Results**

- Most but not all entities were combined but it took longer than expected. Just need to be patient and organized

Question and answers

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