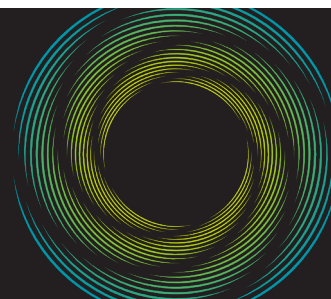


M&A Tax Talk

Distressed market series



Carve-out of financial statements

Companies pursue divestitures for many reasons, including raising capital (among other goals), responding to an economic downturn, facing competitive pressures, or adopting new strategies. When a corporate parent orchestrates a carve-out, spin-off, or sale of a portion of its business, the execution team may be responsible for preparing carve-out financial statements, including a tax provision. Advanced planning could help increase the likelihood of success and should involve tax professionals and advisers as early in the process as possible. Tax matters addressed at the outset of a carve-out process may improve the efficiency of the entire process.

This article examines some of the income tax considerations when preparing carve-out statements and presents pragmatic steps to address this complicated area of financial reporting.

Legal entity structure

When preparing financial statements, it is critical to understand the legal structure of the operations that will be carved out. A carve-out may be a single legal entity, a portion of a single entity, a group of legal entities, business lines with no legal entity, or a combination of entities and business lines. In our experience, legal entities are a practical starting point for creating carve-out statements. Accordingly, we believe it can be beneficial to create a basis of presentation memorandum that identifies legal entities, operations, assets, and liabilities of the business to be carved out. Tax practitioners can add significant value to the process through their understanding of legal entities, transfer pricing, and other structural matters.

Separate return method

As noted above, the operations that will constitute a carve-out business may be held in multiple legal entities or divisions. It's also possible that carve-out operations have historically been included in a single consolidated income tax return of the parent company or in a return filed on behalf of an entity operating in a specific tax jurisdiction. As such, Staff Accounting Bulletin (SAB) Topic 1.B.1 clearly states a preference for the separate return method for allocating income taxes.

ASC 740-10-30-27 describes the separate return method as one in which an entity allocates current and deferred tax expenses to "members" of the group by applying ASC 740 to "each member as if it were a separate taxpayer."

Differing statutory tax rates and applicable tax regulations impact the carve-out business operations in various state and non-US jurisdictions. This may be particularly challenging if the geographic footprint of the carve-out operations is drastically different than the parent's business. As tax practitioners consider the location of carve-out operations, it's important to consider the effect of federal, state, and non-US regulations within financial statements.

Carve-out overview

When preparing carve-out statements, the income statement may reflect "all costs of doing business." Accordingly, in addition to direct expenses, an allocation of indirect expenses would typically be included in the historical carve-out income statement. The balance sheet, on the other hand, would typically reflect only the actual assets

and liabilities that comprise the business being carved out. If certain expenses are not required to be "repaid," such amounts should be recorded to equity as capital contributions.

Similarly, a taxable loss recognized in the carve-out income statement already may have been utilized by the legal entity that is effectuating the separation or by a parent company in the context of a consolidated group. Therefore, the loss may not be available to offset income of the carve-out group after separation. In these instances, consideration should be given to whether the net operating loss should be reflected on the carve-out balance sheet or settled through equity.



Income statement

Permanent items

As noted above, to meet the requirements of a stand-alone company, carve-out financial statements are required to reflect all historical costs of the business¹. Those costs may include unallocated expenses for finance, facilities, professional fees, and other administrative items. Tax professionals should consider assessing these pre-tax carve-out adjustments for tax sensitivity and potential permanent book-to-tax differences. For example, an adjustment related to executive compensation may lead to a permanent addback of the compensation pursuant to Section 162(m). The appropriate limitation can be calculated based on remuneration for affected executives.

State effective tax rate

Companies with multistate operations will have many considerations in a divestiture. For example, carved-out operations may:

- Be located in states other than those of the consolidated group's other operations
- Have a portion of income taxed in a state where they do not operate because of a unitary filing requirement
- Operate alone in a state that requires a unitary filing and therefore subject the consolidated group's income to tax in that jurisdiction

Depending on the circumstances above, individual state tax rates for carved-out operations may be different from those typically applied to the consolidated group. Therefore, tax professionals will need to recalculate apportionment for carved-out operations on a stand-alone basis to determine a reasonable blended state statutory tax rate; or be prepared to explain, quantitatively and qualitatively, why the existing state blended rate makes sense.

Balance sheet

Deferred tax balances

The selected approach to identify deferred tax balances for the carve-out business is often dictated by the level and quality of available information. In some situations, this is straightforward (compare the assets

and liabilities being carved out to the underlying tax basis in such assets and liabilities). In other circumstances, deferred balances may not be easily identifiable (for example, a Section 263A adjustment calculated based on absorption percentages not identifiable in the carve-out). Therefore, tax professionals should evaluate all available information to help calculate deferred balances for carve-out operations.

Tax attributes

As noted above, calculating and reporting deferred tax assets associated with the company's attributes (such as net operating losses and tax credits) poses challenges when preparing carve-out statements. In practice, such attributes may have been utilized by the legal entity that is effectuating the separation or by a parent company in a consolidated group and may not be available to offset income of the carve-out group post-separation.

Taxes payable

The calculated amount of federal and state taxes payable in carve-out statements likely will differ from the amount previously recorded by the entities comprising carved-out operations. It is important to note that taxes payable or receivable balances calculated on a carve-out basis will not result in a change to cash tax payments or receipts; therefore, organizations should consider how they identify the taxes payable or receivable to include in the carve-out statements. One such consideration would be whether the legal entity bears the ultimate responsibility for paying the tax. For example, a tax that is owed by a carve-out legal entity to a state where such entity files a separate tax return should likely be included on the balance sheet of the carve-out statements.

Uncertain tax benefits

A consolidated group may have certain unrecognized tax benefit liabilities that result from the activities of the whole group and may have unrecognized tax benefits that directly relate to the activities of carved-out operations. Tax professionals should determine an appropriate method for allocating uncertain tax positions to carve-out financial statements. One such

consideration would be to assess which liabilities represent an actual legal obligation of a legal entity that is being carved out and therefore may transfer with the business upon separation. Using this approach, tax professionals should assess uncertain tax benefits on a legal-entity basis and determine which positions may be impacted by the carve-out operations or may be settled by a carve-out legal entity.

Conclusion

Regardless of a company's divestiture hypothesis, early and continuous involvement of tax professionals in preparation of carve-out financial statements will help to facilitate a successful process. For example, consideration of issues like legal entity structure and jurisdictional footprint may not be "top of mind" to non-tax professionals at the outset of the process, but are extraordinarily relevant for tax purposes and should be addressed sooner rather than later.

Want to learn more?

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¹ US Securities and Exchange Commission (SEC), "Codification of Staff Accounting Bulletins – Topic 1: Financial Statements," last modified March 9, 2011, <https://www.sec.gov/interps/account/sabcodet1.htm#B>

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