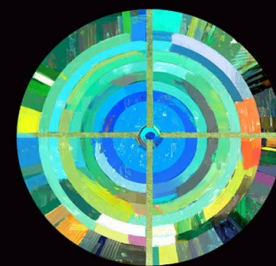


M&A Tax Talk

Tax considerations when selling a subsidiary out of a consolidated group



In today's market-driven approach to M&A, many companies are constantly examining their business to determine whether all of their operations align directly with the primary objectives of the organization. Any activities that are identified as "non-core" may be good opportunities for divestiture, allowing them to thrive under different leadership or with a different capital structure and investor base. However, while such transactions can unlock hidden value for sellers by generating cash flow to reduce debt or invest in growth opportunities, tightening management's focus, and improving shareholder value, such transactions often present complex tax considerations for both buyers and sellers.

A prepared seller considering a divestiture of a non-core segment will want to consider how the tax rules affect the after-tax proceeds and identify tax benefits for potential buyers that can drive significant deal value.

In many cases, structuring alternatives and elections may be available to improve the tax consequences for one side or the other—or, in some cases, both sides.

This article discusses some of the tax considerations that a seller should be aware of when deciding to sell a subsidiary from its consolidated group. Due to the complex modeling and detailed historical tax review that is often required, a seller looking to enhance value should become familiar with the tax profile of the business as early in the process as possible.

Why does structure matter?

A disposition may produce widely different tax consequences to the seller, depending on how it is structured. In a taxable sale of stock of a corporate subsidiary, the seller generally recognizes capital gain or loss on the difference between the selling price and the seller's basis in the stock of its subsidiary. On the other hand, in a taxable sale of assets, the seller will recognize gain or loss on the difference between the selling price plus assumed liabilities and the adjusted basis of the assets of the subsidiary (which could be significantly different if, for example, the subsidiary was previously acquired). This gain or loss may be classified as capital, ordinary, or governed under section 1231, depending on the underlying assets sold.

In some cases, a transaction that is legally structured as a stock sale may be treated as an asset sale for US tax purposes, achieving the legal and operational benefits of a stock sale and the tax benefits of an asset sale (for example, where the subsidiary is a limited liability company that is disregarded for US tax purposes or where the parties agree to make a section 338(h)(10) or 336(e) election).

There are tax and commercial factors that need to be weighed when choosing an acquisition stock structure. Stock sales tend to be simpler and faster to execute, while asset sales generally decrease the risk of assuming potential unknown or contingent liabilities contained in a distressed target company. From a tax perspective, a buyer may prefer to obtain a basis step-up by structuring the transaction as an asset sale

or by making a section 338(h)(10) or 336(e) election (especially if a significant portion of the assets are available for accelerated depreciation or amortization) rather than acquiring net operating losses (NOLs) that may be subject to a section 382 limitation.

A seller who can identify these considerations before the sales process begins is often in a better position to steer the conversations around structuring and demand additional value for tax benefits.

Isn't my basis just what I paid?

Unlike stock basis in a nonconsolidated corporation, which remains relatively constant, the basis in a member of a consolidated tax group is adjusted annually to reflect the economic results of that subsidiary's operations for the year (its income, losses, and distributions) or in other situations, such as a disposition. The purpose of these "investment adjustment rules" is to avoid duplication of tax on the seller's investment gain which is attributable to its subsidiary's accumulated earnings that have already been taxed to the group in the consolidated return and to prevent a double deduction for losses that have already been utilized by the group in computing consolidated tax liability.

In addition, the basis of stock may be reduced to prevent a noneconomic loss from being recognized on the sale of a subsidiary. This can happen, for example, when a subsidiary that was previously acquired (without a section 338(h)(10) election) sells pre-acquisition assets at a gain, increasing

the basis in the stock of the subsidiary. A correct stock basis is vital to accurately calculate the gain or loss on a potential disposition. Because most companies typically do not track their subsidiaries' stock basis on a year-by-year basis, a detailed analysis may need to be performed, which could require a review of every tax return and every intercompany transaction since the subsidiary was formed. Due to the complexity of this exercise, it may be beneficial to begin the analysis as soon as possible.

Negative basis and other considerations

In general, transactions between members of a consolidated group are not currently taken into account for tax purposes; such amounts are either deferred or result in an "excess loss account" (which is treated similarly to "negative" basis). Deferred intercompany gains or losses and excess loss accounts often arise from intergroup restructurings or cash movements, as well as the settlement of intercompany debt, but are typically irrelevant to the group's ongoing tax profile. Upon a triggering event, such as a disposition of one of the parties to the intercompany transaction, however, any deferred intercompany gains or losses and any excess loss accounts are immediately taken into account. In some cases, these "bad" attributes can cause the seller to recognize more gain than the proceeds it receives.

Other issues may present themselves upon the sale of a subsidiary, depending on its particular tax profile. For example, the timing of certain income and deductions can be affected by the closing of the subsidiary's tax year; transactions or expenses related to the sale or occurring on the closing date could get allocated between the pre- and post-closing tax periods in a manner that differs from the parties' expectations; and certain items like overall foreign loss accounts could get recaptured into income.

Where did my NOLs go?

Tax attributes may provide value in the form of future cash tax benefits. Preserving as much of the subsidiary's tax attributes as possible may yield additional value for the seller to capture from a buyer. Alternatively, where a seller expects to recognize gain on the sale of its subsidiary, it may wish to use its subsidiary's attributes to shield the gain. If a section 338(h)(10) or 336(e) election is made, the net operating losses and other tax attributes of the subsidiary remain with the seller and do not carry over to the buyer. As such, any available attributes may be used to offset the gain recognized on the disposition of the subsidiary. If any attributes remain, the consolidated group may continue to utilize them going forward.

In a straight stock sale, however, the seller must determine the portion of its overall tax attributes, if any, that belong to the subsidiary. In a tax-consolidated group, the tax attributes of one member of the group can generally be used to offset the taxable income generated by another member of the group without limitation. As a result, the location of the tax attributes is often irrelevant and is not tracked within the group. The location of the attributes becomes important, however, when a subsidiary is sold, because the tax attributes belonging to that subsidiary transfer over, subject to applicable limitations. As such, a detailed analysis may be necessary to determine the extent to which the subsidiary contributed to the group's overall net operating loss balance and other tax attributes. This exercise may be costly and intricate, depending on the complexity of the group, how long the subsidiary has been a member, and its contributions to the group's attributes.

Furthermore, the extent to which the subsidiary's losses and deductions can be used in the year of the subsidiary's disposition is limited. For instance, the

subsidiary's losses generated in the year of disposition may not be used to shelter the gain recognized by the group on the disposition of the subsidiary itself.

Moreover, if the consolidated group recognizes a loss on the sale of a subsidiary (after applying the basis adjustment rules), a portion of the subsidiary's tax attributes (including the inside stock basis) may be reduced unless the group elects to forgo the loss or elects to reattribute such attributes to itself, and even those attributes that remain will generally be subject to limitation under section 382.

Conclusion

Understanding the tax consequences of a sale of subsidiary out of a consolidated group can be complicated. Complex modeling and a review of prior tax returns are often required to determine the amount and character of the gain or loss the selling group will recognize, as well as the amount of net operating losses and other tax attributes that the buyer will obtain. The parties often have the option to make various elections that impact the calculations—to reattribute the losses of the sold subsidiary to the seller, to forfeit a stock loss to preserve inside tax attributes, or even to treat a stock sale as an asset sale for US tax purposes. Moreover, the importance of these factors will often depend on the current and forecasted tax profile of the buyer and seller, requiring an approach tailored to parties' specific situations. In some cases, the parties may be aligned in their desires, but in other cases, the form of the transaction and the US tax consequences may be subject to negotiation. Since M&A transactions can move quickly, taxpayers who proactively perform these analyses can often be in a better position to reduce taxes and identify tax synergies for the buyer to drive meaningful value in the sale process.

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