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M&A Tax Talk

Divestiture-related tax considerations

Understanding certain tax implications for sellers...and buyers

If you've ever sold a home, you know that preparation is key to achieving the best price. You make minor repairs, upgrade outdated appliances, put on a fresh coat of paint, and stage the home to make it attractive to potential buyers.

In many ways, selling a business is similar, except that your preparation is different. Specifically, it is critical to develop an understanding of the tax work that should be addressed in advance of starting negotiations.

Tax opportunities and implications

There are many reasons why management may consider divesting a business line or an entire company, including increased competition from new startups and disruptors, rising manufacturing costs, or changing market trends. No matter the reason, however, tax considerations that impact the seller and the buyer should be a key part of the seller's divestiture process. The impact of US tax reform legislation (i.e., the Tax Cuts and Jobs Act of 2017) should also be evaluated during the transaction planning phase with a focus on identifying tax efficiencies for both buyer and seller.

Structure

A key priority for buyers and sellers is to develop an in-depth understanding of the various tax structuring alternatives that may be considered. Why? Because a transaction's structure can have tax consequences that extend beyond the closing date and may be impactful to the overall decision-making process.

Generally, buyers seek opportunities to obtain a step-up in tax basis allowing them to benefit from additional cost recovery deductions through future depreciation and amortization. Recent US tax legislation has made tax basis step-ups more desirable through provisions that allow for immediate expensing of value allocable to qualified assets.

As such, sellers should consider whether there is an opportunity to structure the transaction so that a buyer can achieve this tax basis step-up and leverage any incremental value it may provide. Further, sellers should also consider the tax cost of a structure that allows for a tax basis step-up so that such costs may be factored into the determination of the purchase price.

In assessing the preferred transaction structure, a cost/benefit analysis may provide sellers with useful insights on these potential tax opportunities and any incremental costs associated with the deal. A cost/benefit analysis may also help sellers consider the impact of existing tax attributes, such as the difference between selling stock and transferring existing tax attributes (e.g., net operating losses and tax credits) to buyers versus selling assets and using available attributes to offset gain realized on the sale.

Early indicators of divestiture

While you may not be the one making the ultimate decision to divest, it is important to be prepared. The following are certain indicators that a divestiture could be on the horizon:

- An activist shareholder group
- Changes in management team
- Existence of noncore assets/divisions
- News reports indicate a breakup
- PEI owned/end-of-investment period
- Succession planning
- Merger transaction activity in the sector
- Preliminary divestiture discussions
- A business unit doesn't align with company's overall strategy
- Funding needed for future acquisition

Address risk, and focus on preparedness

It is often helpful for sellers to understand the tax profile and risks, if any, the buyer may inherit after completing a transaction. A tax vendor due-diligence report will provide buyers with an overview of the tax profile and suggested areas of focus for buyers during due diligence. Tax factbooks may also be used during the sales process to provide buyers with a broad-based view of a company's current and historical tax profile.

In many cases, summarizing such tax information in advance of a transaction can speed up the due-diligence process for sellers by helping them identify potential problems and situations that may otherwise be overlooked and, at a minimum, summarize the tax data a buyer will request. Gathering the necessary information to prepare these materials is a good exercise for identifying data gaps that may surface when addressing a buyer's tax due diligence information requests. Further, depending on the transaction time frame, there may be opportunities to address potential exposures through varying processes such as amended return filings or voluntary disclosure agreements.

Financial statements

As the sales structure is finalized, consideration also should be given to the need for audited carve-out financial statements, which may be necessary to support a buyer's public filing or to better define the operations of the business being sold.

By comparing the size of the business being divested relative to the potential buyer's existing operations (i.e., a significance test), the seller can make a preliminary determination as to whether audited carve-out financial statements may be a necessary part of the sale process.

Because the preparation of carve-out financials requires extensive financial and tax analysis, it is critical to begin this work as early as possible.

Conclusion

Motivated sellers need to be proactive to try and secure the best deal possible in the shortest amount of time. This means creating a situation where they can secure a fair (or better) price for the assets they are divesting while, at the same time, demonstrating to the buyer that they have received good value for their money.

Because tax implications can have a significant impact on the potential costs and benefits of a divestiture, it is critical for sellers to identify and address the key issues that potential buyers are likely to face when contemplating a purchase, and to try to address these concerns early on to streamline the sales process. Consulting experienced professional tax advisors early in the sales life cycle can help put both sellers and buyers into favorable positions to begin and end the negotiation process and deliver value to all parties involved.

Want to learn more?
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