EY
Building a better working world

Will you set the divestment pace, or try to keep up with it?

Global Corporate Divestment Study 2019
Spotlight on Tax

ey.com/divest/tax

The better the question. The better the answer. The better the world works.

According to the EY *Global Corporate Divestment Study*, companies that intend to divest remain at record levels, with 84% of companies looking to divest within the next two years. C-suite executives say tax continues to play a key role in divestment success, providing significant opportunities to reduce value erosion, manage risk and enhance deal flexibility.

> "Looking at your business, early in the sales process, through the eyes of a skeptical purchaser is critical to understanding the tax impact. Understand what buyers will see as significant tax value and risk, and make sure that these are articulated well and supported within the sales process."
>
> **Bridget Walsh**
> EY Global Head of Transaction Tax

Tax policies continue to have a major impact on businesses. The continuing impact from US tax reforms and Base Erosion and Profit Shifting (BEPS), alongside reputational risk, has meant companies have to adapt to a constant backdrop of change. With 45% of companies reporting an increase in tax challenges impacting the ease of executing deals (up from 31% last year), finding ways to address these challenges has never been more important.

With the right preparation up-front, a seller's tax approach can be a powerful tool to preserve value by providing flexibility in sales structure and build defenses to support tax uncertainties. This approach can also enhance value by supporting tax attributes (ensuring their value is considered in the commercial negotiation) and ensuring that tax is appropriately considered in the effectiveness of changes to the operating models.

Here we focus on three of the key tax findings coming out of the study — value erosion, flexibility and operational integration.

66% of companies say lack of preparation in dealing with tax risk was a cause of value erosion in their last divestment.

Lack of preparation around tax risk has consistently ranked as a top cause of value erosion year over year. Conversely, 63% of companies say they undertook pre-sale preparation to mitigate the price reduction for tax risk. So why is value still being lost?

Preparation often begins with sell-side due diligence. Commonly, value is lost when sellers identify tax risks in the first stage of preparation, but then fail to act to clarify and potentially mitigate those risks before the process starts. Bringing tax into the divestment strategy earlier can allow sufficient time to undertake an open assessment of the business through the eyes of a buyer, address issues identified, and only then commence diligence. It is not only how a vendor sees tax risk and opportunities that is important, but how a buyer would look at them from the outside in — which is easier said than done.

Negative value adjustments can occur where a seller underestimates the tax perspectives from a widening pool of buyers, including private equity and cross-sector. Preparing for these conversations may require sellers to review historical tax advice and the trail of why positions were taken to help provide the reassurance and granular data a purchaser requires — in some cases resulting in pre-sale tax authority clearances and negotiations.

If it is not possible to bridge the gap in tax views between buyers and sellers, the warranty and indemnity and tax insurance market can be an effective way to take protective measures around exposures.

48% of companies report that the ability to achieve a higher sale price by offering flexibility in sales structure has increased in the last 12 months.

While 57% of companies say lack of flexibility in the sales structure eroded value, a significant number of companies who demonstrate flexibility are seeing a positive impact on their sale price. To improve flexibility, companies can start by weighing the tax impacts of different structures.

Tax teams should work alongside M&A teams early in the process to fully understand all commercial options, analyzing and modeling tax cost or saving of different structures. In tax free spin-off or demerger transactions, early analyses should include evaluation as to whether the proposed transaction can meet the tax requirements and regulations to achieve a tax-free transaction. This allows time to dive down into key tax variables, including potential exit structures, vendor costs, tax attributes and highlighting value perception on the buy-side (e.g., tax benefit of basis step-up) leading to a fuller and more flexible set of options, tax costs and benefits.

Trying to build in flexibility in the middle of a deal, with competing asks and time pressures, can mean value is lost when there is insufficient time to react with any degree of accuracy. Thinking about this up front supports greater agility, allowing sellers to make changes as external circumstances move, buyers' priorities change or other issues arise.

One of the side effects of US tax reform is that US multinationals are generating even more detailed tax attribute information on a current basis to assist in new computations required under US tax reform. Having data regularly updated and on hand can assist tax functions in evaluating alternative disposition structures as they look to build in flexibility on the sale.

> “Buyers are demanding more granular detail. They want issues thought through and resolved early. Value is lost when companies do not do this upfront.”
>
> **Todd Miller**
> US Transaction Tax Partner, Ernst & Young LLP

Businesses built on years of acquisitions, complex operating models or shared service centers are often intertwined across many functional levels. And fifty percent of companies say failure to present the business as stand-alone "scared off" potential buyers, eroding value on their last divestment. Sellers need to articulate a clear plan to achieve a stand-alone operating model and communicate a day one transitional operating model. Thus, time can be well spent disentangling the business for sale before the formal process.

Divestitures can create tax value as the stand-alone operating model of a business is restructured to better match the post-sale commercial strategy and synergies. The key is to think of the divested business as a business in its own right which means for that business: what is the most efficient operating model, where should its people be based and what capital structure should it have. Understanding the tax profile is a key consideration in this process.

Where the deal team has operations and tax working together, tax implications of separation (e.g., intercompany loans, historic transfers of assets) and their impacts on tax can flow seamlessly into wider workstreams. Understanding this is critical to avoiding surprises and managing messaging to wider teams.

For a divested business to continue operating without significant business interruption, companies are frequently using delayed close mechanisms — a period where the legal ownership remains with the seller, but the net economic benefit is with the purchaser. Tax can often bear the brunt of risks in such situations with complexity and interdependency from direct taxes, indirect taxes and increasingly, tariffs. Close operational workstream alignment, including tax, can help manage the additional risks this arrangement can create.

56% of executives say a lack of understanding around workstream interdependencies delayed or derailed closing.

Using insurance to achieve certainty on tax risks

A growing trend in the market has been the use of tax insurance to bridge the perception gap between buyer and seller. Where a seller is unwilling or unable to provide contractual protection in respect of historic tax liabilities, the insurance market can often provide a commercial solution, avoiding the need for protracted negotiations and saving significant time and cost.

In our experience the market for insurance has shifted significantly over recent years, both in terms of pricing and extent of cover. For example, with the right fact pattern it can now be possible for low risk/quantum diligence exposures not to be carved out from policy coverage, as was previously the market standard. Further, specific more significant tax risks can now often be insured separately as insurers have greater in-house tax expertise and capacity to insure specific tax risks.

However, insurers will require sufficiently detailed diligence to be comfortable they can provide cover. Matters and jurisdictions which have not been covered in diligence will not be insured. Identification of tax risks that may need to be insured prior to sell-side due diligence is vital to ensure the scope of that due diligence is sufficient.

About this study

The EY *Global Corporate Divestment Study* focuses on how companies should approach portfolio strategy, improve divestment execution and future-proof their remaining business. The 2019 study results are based on 1,030 interviews with 930 senior corporate executives and 100 private equity executives. The survey was conducted between September and November 2018 by Acuris.

Connected Capital Solutions

Whether you're preserving, optimizing, raising or investing, our Connected Capital Solutions can help you drive competitive advantage and increased returns through improved decisions across all aspects of your Capital Agenda.

Enabling fast-track growth and portfolio strategies that help you realize your full potential for a better future

Enabling better decisions around financing and funding capital expansion and efficiency

Enabling strategic growth through better-integrated and operationalized acquisitions, joint ventures and alliances

Enabling strategic portfolio management, and better divestments to help you maximize value from a sale

Helping you transform or restructure your organization for a better future by enabling business-critical and capital investment decisions

Read our industry reports
ey.com/divest

- Advanced manufacturing
- Consumer
- Financial services
- Life sciences
- Media and entertainment
- Private equity
- Technology

To learn more and to have a conversation about your divestment strategy, please contact us:

Bridget Walsh
EY Global Head of Transaction Tax
bwalsh@uk.ey.com
+44 20 7951 4176

Ian Scott
EY Asia-Pacific Transaction Tax Leader
ianscott@au.ey.com
+61 2 9248 4774

Paul Hammes
EY Global Divestment Leader
paul.hammes@ey.com
+1 312 879 3741

Rocio Reyero Folgado
EY Europe, Middle East, India and Africa Transaction Tax Leader
rocio.reyerofolgado@es.ey.com
+34 9 1572 7383

Torsdon Poon
EY Americas Transaction Tax Leader
torsdon.poon@ey.com
+1 213 977 3183

Masako Kanaya
EY Japan Transaction Tax Leader
masako.kanaya@jp.ey.com
+81 3 3506 2430

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

About EY's Transaction Advisory Services
How you manage your capital agenda today will define your competitive position tomorrow. We work with clients to create social and economic value by helping them make better, more-informed decisions about strategically managing capital and transactions in fast-changing markets. Whether you're preserving, optimizing, raising or investing capital, EY's Transaction Advisory Services combine a set of skills, insight and experience to deliver focused advice. We can help you drive competitive advantage and increased returns through improved decisions across all aspects of your capital agenda.

©2019 EYGM Limited.
All Rights Reserved.

EYG no. 001034-19Gbl
BSC No. 1808-2831826

ED None

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax or other professional advice. Please refer to your advisors for specific advice.

ey.com