



Tax-free spin-off roadmap

Improving capital allocation,
operations and investor focus



EY

Building a better
working world



Creating value by spinning off

Spin-offs are tax-efficient transactions that can create value in three key ways:

- ▶ More focused capital allocation, including M&A, because SpinCo can control free cash flow and investment decisions
- ▶ Improved operations through management focus on core business and removing redundant systems and infrastructure
- ▶ Better alignment with investor preferences (e.g., risk exposure, capital structure and industry)

Spin-off variations

While here we discuss a traditional tax-free spin-off, there are some similar transaction types that you may consider:

- ▶ **Morris Trust** – Following a spin-off, a third party acquires stock representing less than 50% of the vote and value of *RemainCo*.
- ▶ **Reverse Morris Trust** – Following a spin-off, a third party acquires stock representing less than 50% of the vote and value of *SpinCo*.
- ▶ **Sponsored spin** – A private equity or other investor acquires less than 50% of *RemainCo* or *SpinCo*.

These variations may also be effectuated in a split-off, in which *RemainCo* redeems a portion of its stock in exchange for *SpinCo* stock.



The challenges

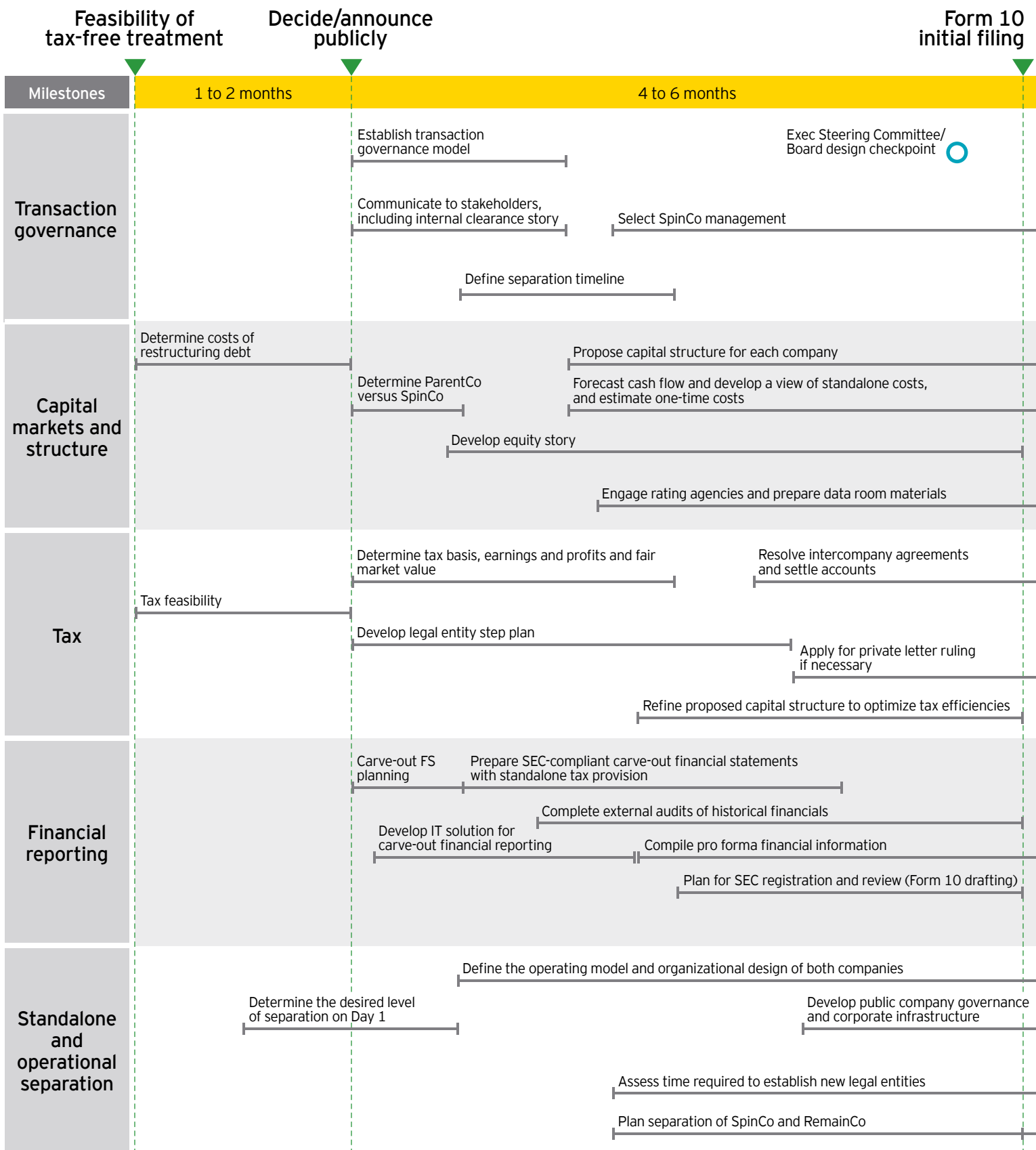
In its operational, regulatory and strategic complexity, a tax-free spin-off is something of a three-headed beast: as demanding as any business carve-out, with added requirements akin to those of an initial public offering (IPO), plus the close involvement of tax authorities and the Securities and Exchange Commission (SEC).

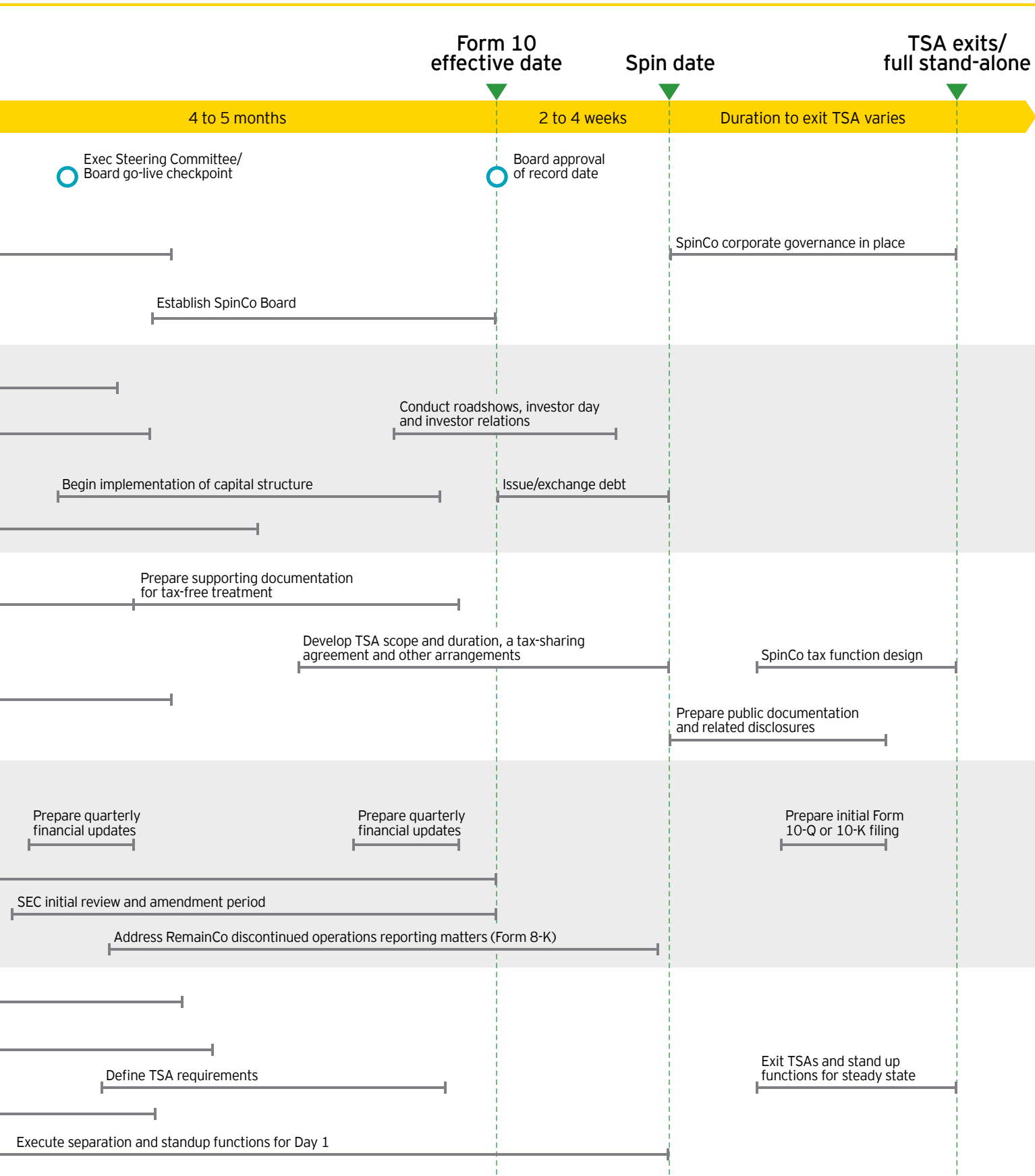
All this adds up to an undertaking whose challenges, costs and pitfalls are not to be underestimated. Challenges can include lost synergies, potentially high transaction and tax costs, separation of talent, SpinCo/RemainCo conflicts of interest, regulatory hurdles and business disruption.

The answer

Considering the vast dispersion of returns that companies experience post-spin, here we outline the most critical steps to understanding whether or not a spin-off is feasible and how to complete a successful deal.

Spin-off timeline







Critical steps to managing a successful deal

Feasibility of a spin's tax-free treatment

Tax-free spin-offs are extremely complex and must satisfy many legal and regulatory requirements. Failing any of those requirements can result in shareholder and/or corporate-level tax. Understanding potential spin-off capital structure and associated costs is also critical in making a transaction decision. Below are key analyses to determine if a transaction is feasible from a tax and capital structure perspective.

Will a tax-free spin-off achieve your business objectives?

- ▶ A spin-off must effectuate a complete operational separation of RemainCo and SpinCo, and RemainCo generally must distribute all of its stock of SpinCo.
- ▶ Both RemainCo and SpinCo must have at least one qualifying active trade or business (ATB) that has been conducted continuously for five years immediately prior to the spin-off.
- ▶ A tax-free spin-off cannot be part of a shareholder plan to dispose of a controlling interest in either RemainCo or SpinCo, which can significantly restrict post-spinoff M&A activity.
- ▶ Spin-offs present only a limited ability to monetize SpinCo value.

Do you have a valid corporate business purpose for the spin-off?

- ▶ The spin-off must be motivated in whole or substantial part by a real and substantial non-federal tax purpose germane to the business of RemainCo, SpinCo, or their respective affiliates (i.e., a shareholder purpose alone does not qualify as a "corporate business purpose").
- ▶ The corporate business purpose needs to clearly demonstrate the need for the spin-off.

Do RemainCo and SpinCo each have an ATB?

- ▶ Both companies must have at least one qualifying ATB, which means more than simply "conducting a business".
- ▶ The ATB's key business functions must be performed by employees of RemainCo, SpinCo or their affiliates; independent contractors are excluded from the analysis.

Can you restructure your outstanding debt in a tax-efficient way?

- ▶ A spin-off can require a company to restructure its debt, potentially at a large or prohibitive cost.



Transaction governance

Establish a spin-off transaction governance model – don't underestimate the importance executing these seemingly routine tasks:

- ▶ Define spin-off game plan, form transaction team and communicate objectives to kick off the transaction efficiently and avoid a slow start
- ▶ Decide which internal and external stakeholders should know about the transaction and strategic plans before they are public, and develop messaging accordingly
- ▶ Set targets, delegate and monitor progress through reporting in order to manage the complexity of a spin-off and maintain accountability
- ▶ Define the separation timeline and align work streams to key deadlines and milestones to maintain momentum, track progress and target the desired close date
- ▶ Consider the appropriate role of SpinCo management; SpinCo management is typically involved in SpinCo organizational design and setting the strategic vision because it will be responsible for execution
- ▶ Establish board of directors' oversight and knowledge of key events through the entire process; there should be routine dialogue between the board and management

Capital markets and structure

Capital structure

Propose capital structure for each company based on its cash flow and growth profile

- ▶ Review terms of outstanding debt; consider debt to target for exchanges and restructuring in order to minimize transaction costs
- ▶ Determine how historical liabilities will be split (e.g., pension obligations)
- ▶ Assess Day 1 cash requirements because the companies' existing cash may not be sufficient for working capital needs

Forecast cash flow and develop a view of standalone costs

- ▶ Will be an input into the pro forma Form 10 disclosures and debt and equity roadshows
- ▶ Helps determine interest and dividend payments available to the market
- ▶ Determine one-time costs and who will pay in order to assess funding needs

What's being distributed

Determine which business will be retained (i.e., RemainCo) and which business will be distributed (i.e., SpinCo)

- ▶ Legal and/or regulatory restrictions may limit asset/stock transfers
- ▶ Distributing business with lower inherent tax gain may be preferred

Determine profile of the stock to be distributed (e.g., voting rights, distribution ratio, dividend policy)

- ▶ Consider the distribution ratio and a reverse stock split if the anticipated share price is suboptimal
- ▶ A split-off may benefit from a subsidiary IPO to set the market price, allowing for an exchange offer

Develop the equity story for roadshows to garner sufficient market interest and avoid post-close sell-off



Critical steps to managing a successful deal

Tax

Develop legal entity step plan

- ▶ Mitigates potential business, operational, financial and tax impediments and costs
- ▶ Legal entities with commingled operations, multiple non-US jurisdictions, and legal or regulatory restrictions on transferability of assets drive transaction complexity
- ▶ Legal and/or regulatory restrictions may limit asset/stock transfers

Determine tax basis, earnings and profits (E&P) and fair market value (FMV)

- ▶ Appreciation (i.e., excess FMV over tax basis) of the existing businesses may drive the decision regarding the identity of RemainCo and SpinCo
- ▶ RemainCo can generally “monetize” its investment in SpinCo to the extent of the tax basis in SpinCo stock
- ▶ The FMVs govern allocation of tax basis and E&P (required for a dividend distribution)

Refine proposed capital structure to optimize tax efficiencies

- ▶ Allocating existing debt may result in an inefficient capital structure
- ▶ May need to issue new debt to avoid tax costs of assuming existing debt

Resolve intercompany agreements and settle accounts to prepare for legal separation

- ▶ Necessary in order to achieve a complete separation
- ▶ Impacts tax basis, value and debt capacity, and may influence the legal step plan

Develop scope and duration of Transition Services Agreements (TSAs), a tax-sharing agreement and other arrangements

- ▶ Companies may not be able to operate completely independently immediately following the spin-off
- ▶ Continuing relationships between RemainCo and SpinCo must be of limited scope and duration and generally must be priced at arm’s length

Prepare supporting documentation for tax-free treatment

- ▶ Contemporaneous support is generally required for tax-free treatment and future audits
- ▶ A tax opinion is necessary in nearly all circumstances – the IRS does not generally issue private letter rulings (PLRs) pertaining to spin-off matters
- ▶ If a company requests a PLR, the tax opinion may address only those matters not covered by the PLR

Prepare public documentation and related disclosures (e.g., tax return disclosures, IRS Form 8937)

- ▶ Required to ensure the company is compliant with IRS and other governmental disclosure requirements



Financial reporting

Invest time up front to properly plan for preparing SEC-compliant historical carve-out financial statements

- ▶ Timely completion of the audited carve-out financial statements (generally a four- to six-month process) is critical to achieve transaction timelines and being able to complete other financial reporting work streams (e.g., MD&A, pro forma financial information, credit rating agency/investor information, etc.)
- ▶ Empower a project manager that understands SEC reporting requirements, sets interim milestones and globally aligns interdependent functions (e.g., management, tax, attorneys, bankers and auditors) in order to prepare carve-out financial statements and complete audits on time
- ▶ Longer lead time items include basis of presentation, corporate cost allocations, push-down of certain assets and liabilities, historical SpinCo acquisitions, goodwill and intangible impairment testing and carve-out tax provisions

Develop an IT solution that aggregates data, posts adjustments and supports statement preparation

- ▶ Having one place to store all data for multiple outputs (e.g., audited and pro forma financial statements, rating agency financials, discontinued operations) can minimize version control issues, data problems and re-work
- ▶ Align with tax to track and compile adjusted information at a granular enough level to enable carve-out tax provisions by jurisdiction

Complete external audits of historical carve-out financial statements

- ▶ Address basis of presentation matters as audited financial statements may not necessarily equal SpinCo deal basis
- ▶ Involve auditors early and often to align on management conclusions and approaches to audit testing and support
- ▶ Lower levels of materiality lead to unaccustomed depth of audit testing

Compile pro forma financial information

- ▶ Adjustments can include impact of new capital structure, impacts of various transaction agreements, asset/liability transfers, employee liabilities triggered upon sale and distribution, and ratio on earnings-per-share calculations
- ▶ Do not underestimate effort required and potential stakeholder scrutiny of standalone and one-time cost disclosures

Plan for SEC registration and review

- ▶ Put forward your best effort into completing the initial Form 10 filing and initial comment letter response to avoid a prolonged review process
- ▶ Understand anticipated timing for initial filing, SEC review process and amendments, reporting deadlines, holidays and “stale” dates
- ▶ It can take four to five months (and four to five amendments) from initial Form 10 filing to SEC declaring your filing effective – important to adhere to publicly communicated timelines
- ▶ Anticipate SEC hot-topic matters (e.g., revenue recognition, segments, executive compensation, MD&A)

Anticipate post-spin reporting matters

- ▶ Plan early as preparation for post-spin filings has to run concurrent to SpinCo's SEC registration process
 - ▶ RemainCo may have numerous reporting requirements, including reporting SpinCo within discontinued operations and filing Form 8-K within four business days from spin date
 - ▶ SpinCo must file its first Form 10-Q for the quarter following the most recent period included in the Form 10 (later of 45 days after the effective date or the date the Form 10-Q would otherwise be due)



Critical steps to managing a successful deal

Operational separation

Define the operating model of both companies

- ▶ Understanding current state operations in detail is key to minimizing delays and cost overruns
- ▶ Define the Day 1 and future state operating model, including employee allocation, and align it to post-spin strategic objectives
- ▶ Right-size the organizations – an optimized future operating model can enhance deal value

Determine level of separation on Day 1

- ▶ Different transaction rationales call for different degrees of separation on Day 1 (e.g., short timeline, complexity to separate systems)
- ▶ Regulatory bodies generally look for complete separation within two years (IT can be the exception)
- ▶ A high degree of separation will accelerate the need to manage RemainCo's stranded costs

Define TSA requirements and governance model

- ▶ Understand requirements and cost to deliver services on Day 1, as well as exit strategy

Assess time required to establish new legal entities

- ▶ Requirements to establish new legal entities vary by jurisdiction and industry and can take over a year to complete
- ▶ Failure to act expediently can delay establishing bank accounts, contracting with vendors, configuring systems, establishing processes, selling product and other activities, and can delay closing

Develop public-company governance and corporate infrastructure

- ▶ Management and the board must be prepared for public-company responsibilities – e.g., they must be ready to file financial statements with the SEC post-close
- ▶ SpinCo can set new corporate governance structure to eliminate legacy challenges



Operational separation Functional separation considerations

IT

IT is often the most entangled functional area; it requires the most lead time; and it's one of the most expensive to separate. Key activities include assessing the current system landscape; allocating systems, capabilities and infrastructure; segregating access and data; defining the Day 1 IT operating model; and, at times, creating separate IT system architectures for SpinCo and RemainCo.

Finance

A spin-off puts strain on the finance organization. Form 10 preparation, separation accounting, as well as SpinCo standup and SEC reporting, create double duties for an organization that still has ongoing business responsibilities.

HR/benefits

SpinCo generally needs to create a new HR and benefits infrastructure:

- ▶ Transferring employees may require union consultations, new country-specific payroll and benefits setups
- ▶ An employee communications strategy should address transition arrangements, time off, compensation, year-end processes and changes to health or pension benefits

Supply chain and manufacturing

Interdependencies can significantly affect SpinCo's Day 1 operating model and separation efforts. Key impacted areas include:

- ▶ Order-to-cash and purchase-to-pay processes
- ▶ Corporate organization and principal company/TESCM model
- ▶ Long-term supply agreements with RemainCo and facilities and logistics networks

Summary

Below we suggest some guiding principles as you navigate the critical steps of a tax-free spin-off:

- ▶ **The spin-off must be motivated by a corporate business purpose** – The IRS has the benefit of hindsight, so make sure that the actions of RemainCo and SpinCo through and following the spin-off are consistent with the stated corporate business purpose.
- ▶ **Don't underestimate Form 10 process timing and complexity** – Form 10 work is not limited to the finance team. It takes a collaborative effort across the organization to complete the registration statement and navigate through a rigorous SEC review process that requires form updates until the SEC declares it effective.

- ▶ **Manage RemainCo and SpinCo conflicts of interest** – RemainCo, which has responsibility to shareholders and decision power until close, should make decisions that best enhance the long-term combined value of both future companies. However, SpinCo management needs to be aligned with decisions as it is responsible for execution.
- ▶ **Understand tax attributes and value** – Effective tax structuring may enable you to “monetize” a portion of your investment in SpinCo prior to the spin-off.
- ▶ **Understand operational separation challenges** – Start early and don't underestimate the lead time or resources needed to separate your business, especially in the Finance and IT functions.

Keeping these principles top-of-mind as you manage the five critical work streams will help you control the process and drive toward a successful tax-free spin-off.

Guiding principles

- ▶ Spin-off must be motivated by a corporate business purpose
- ▶ Don't underestimate Form 10 process timing and complexity
- ▶ Manage RemainCo and SpinCo conflicts of interest
- ▶ Understand tax attributes and value
- ▶ Understand operational separation challenges

Governance

Maintain deadlines and mitigate risks

Capital markets and structure

Optimize the capital structure of both companies based on their separated cash flow profiles

Tax

Separate RemainCo and SpinCo in a tax-free manner

Financial reporting

Manage the **carve-out** audit and Form 10 process; establish financial reporting function in SpinCo

Operational separation

Define operating model changes and their impact on standalone cost structure; implement separation and TSAs for Day 1

Optimize changes to operating model (people, processes and systems)



EY contacts

Paul Hammes
EY Global Divestiture Leader
Chicago, IL
+1 312 879 3741
paul.hammes@ey.com

Rich Mills
EY Americas Divestiture Leader
Atlanta, GA
+1 404 817 4397
rich.mills@ey.com

Blake Pilgrim
Chicago, IL
+1 312 879 6719
blake.pilgrim@ey.com

Regina Balderas
Houston, TX
+1 713 750 1232
regina.balderas@ey.com

Philippe Leroy
New York, NY
+1 212 773 0037
philippe.leroy@ey.com

Mark Schmidt
San Jose, CA
+1 408 947 6678
mark.schmidt@ey.com

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