Houlihan Lokey

HOULIHAN LOKEY CASE STUDY

Portco Separation Planning

When multiples compress, portfolio companies that are likely to sell a carve-out division should consider preemptive tax planning to drive enhanced returns.

Introduction

Despite best efforts, from time to time, sponsor portfolio companies evolve into business enterprises in which the value of the sum of the parts is greater than the whole. This typically occurs when (i) strategic initiatives shift during ownership, (ii) technology evolves quicker than anticipated, or (iii) add-on acquisitions are not integrated successfully. In these situations, exiting the portfolio company in pieces should yield higher returns.

However, for those portfolio companies in which a significant portion of the business is ultimately owned by a corporation,[1] the tax implications of exiting in pieces could be catastrophic. Gains recognized on the disposition of a business unit by a portfolio company taxed as a corporation are generally subject to tax at the corporate level (21%–30%) prior to generating returns to investors, creating a double taxation that eliminates the value premium derived in a sum of the parts analysis.

For sponsor portfolio companies considering a potential exit in pieces, tax planning in a depressed valuation environment is prudent. By triggering or planning for future gains in these environments, one can reduce the tax friction—and drive higher returns—on ultimate exit.

This article will consider the tax implications of:

1. Selling and distributing assets from a corporation,
2. The potential upside to tax planning in a low valuation environment, and
3. Key considerations on legally separating business divisions for tax purposes ahead of a future exit.

Houlihan Lokey can assist you with the tax, accounting, valuation, and IT considerations when exiting a portfolio company through the sum of its parts.

Divesting Business Divisions From C Corporation Portfolio Companies

There are two primary reasons why significant tax challenges arise when exiting a division from a C corporation:

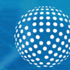
1. C corporations are subject to U.S. federal and state income tax.
2. The acquisition of a business enterprise held as a C corporation is typically effectuated as a stock purchase in which there is no tax basis step-up in the inside basis of the assets.

When a financial sponsor acquires a business through the acquisition of stock of a C corporation, the premium paid on acquisition results in a high-cost basis in the shares of the C corporation.

However, the tax basis of the assets owned by the C corporation is not stepped up *(say goodbye to those goodwill and intangible assets for tax purposes).*

As a result, a subsequent sale, distribution, or exchange of a division of the C corporation for property (typically cash) is subject to corporate income tax based on the differential between the transaction value and the low tax basis of the C corporation's

[1] This article primarily focuses on platform companies that are C corporations for illustrative purposes. However, the same analysis should apply in situations where a private equity platform portfolio company is taxed as a partnership but has significant blocked ownership at the fund level or significant operations held in a C corporation below the partnership platform company.



assets. Temporary tax deferral can be achieved if the assets are exchanged for buyer equity in a tax-free reorganization or contribution to a partnership; however, any subsequent sale of that equity or partnership interest will remain taxable to the C corporation.

U.S. tax law has done a tremendous job eliminating the potential for a C corporation to divest an asset with a built-in gain without paying tax. The main route to achieve the separation of assets from a C corporation without recognizing gains is a tax-free spinoff. For a variety of reasons, a traditional sponsor portfolio company is often ineligible for a tax-free spinoff.[2]

All Hope Is Not Lost

Coming back up from the dark side, there are fact patterns that lend themselves to separations with minimal tax friction. If the initial purchase was acquired with a tax basis step-up (e.g., the platform C corporation was acquired with a 338 election) or subsequent add-ons have been asset acquisitions for tax purposes, there may be higher inside asset basis than we've thus far considered.

Depending on the alignment of the tax basis relative to value in the divisions, the sum of the parts analysis may indicate that there is a large built-in gain in one division but a loss/manageable built-in gain in the other. In such a situation, reversing the separation may yield significant benefits. Rather than separating the high-flying, potentially emerging division from the C corporation (even if that is the intended result), one could separate the low-value division at a much lower tax cost (ideally none) and then sell the high-cost basis stock of the remaining C corporation to shield investors from double taxation.[3]

Herein lies the need for prospective tax planning when a portfolio company may ultimately be sold in pieces. By undertaking separation planning when market comparable companies are trading at low valuations and outlooks are uncertain, the tax implications of the separation may be significantly more palatable than waiting until the market rebounds. In addition, future growth in the division from operational enhancements and M&A activities conducted post separation accrete to sponsors more tax efficiently.

Key Considerations

As discussed above, the separation of a business division with a built-in gain is likely to result in current tax consequences dictated by the valuation of the business division upon separation.

Taxpayers should document valuation considerations on separation for tax purposes, which may require legal entity valuations, an analysis of pricing in connection with ongoing business relationships between the business divisions, and an analysis of any key terms of equity issued to related parties in exchange for the separated division. The tax on these separations may be due at a time that is still months to years from an actual monetization event, so, clearly, the potential tax costs should be weighed against the risk that a business division may not ultimately be exited separately or achieve future increases in performance.

The tax and valuation aspects of the pre-exit separation may be more straightforward than other aspects, though. Like any divestiture, portfolio companies will also need to ensure that plans are clear with respect to financial reporting, IT infrastructure, economic incentives for management, and financing arrangements, among others.

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[2] Among other reasons specific to sponsor-backed portfolio companies, both the distributing corporation and spun-off corporation must have engaged in an active trade or business throughout the five-year period ending on the date of the spin-off; the qualifying trade or business must not have been acquired in a taxable transaction within the past five years; the recipient shareholders must maintain a continued interest in both corporations following the spin-off; and the recipient shareholders cannot hold a 50% or greater interest in the distributing or spun-off corporation as a result of purchasing stock in the portfolio company within the past five years.

[3] In situations where divestiture is accomplished in a manner other than an outright sale, losses triggered may be suspended or potentially foregone in full, so it is best to consider in such analysis that gain is recognizable but the tax benefit of a potential loss is not.

Separating divisions for tax purposes does not necessitate the need for separate company financials or separate financing arrangements, but it may be prudent to prepare standalone financials for each business division/legal entity. First, the separated divisions will need to retain integrity as standalone businesses for tax purposes. This entails properly compensating each other for related party transactions and managing cash flows to avoid situations in which cash built up in one entity is necessary to fund the growth or liabilities of the other. Second, the early separation may provide needed incentives to build up standalone financial reporting, IT infrastructure, or deal-based financials to facilitate a more successful exit.

Conclusion

For those portfolio companies that have a very real possibility of being sold in parts versus one consolidated business enterprise, financial sponsors may optimize the tax consequences on exit by considering business division separations in times of compressed multiples. These separations carry complexity on separation and ongoing maintenance, but the tax savings on exit may far outweigh the implementation costs when compared to selling a high-value business division out from under a platform company in future periods. Houlihan Lokey's cross-functional divestiture team is available to assist you in scenario planning and the implementation of portfolio company separations and divestitures.

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