Pre-IPO tax strategies for enriching shareholder value

Planning to go public

If your vision for value creation includes going public, start acting like a public company well in advance of entering the capital markets. Senior executives can use these eight initial public offering (IPO) tax strategies to enrich shareholder value, leading to ***greater IPO success***.

Eight tax strategies for greater IPO success:

1. Put financial statements in order
2. Analyze legal entity structure
3. Identify uncertain tax positions
4. Analyze deferred tax assets and liabilities
5. Mitigate tax return filing exposures
6. Evaluate net operating loss carryforwards and other tax attributes
7. Build an independent tax team
8. Assess non-income tax considerations

Enriching shareholder value

When a business is private, only closely held stakeholders may have access to the inner-workings of the company. As a business enters the capital markets, its financial statements and disclosures are intensely scrutinized for red flags indicating financial, operational, and governance issues relative to both the company and shareholders. When those red flags are recognized in the capital markets, the company's initial stock price may drop and its IPO may underperform, as Facebook's IPO did back in 2012.

> *Despite being one of the most hyped offerings of 2012, Facebook's initial stock price of $38 in May 2012 quickly lost 50% of its value in subsequent weeks. Recognition of negative tax implications after the IPO were identified as a potential reason the social network's stock failed to gain immediate momentum (Stephen Gandel, CNNMoney, May 2012).*

A goal of businesses going public should be to debut with clean financial statements that accurately reflect a solid financial position – one that supports the offering price – and minimal exposure items that could potentially weaken that position. With the right planning, you can take steps to anticipate and minimize adverse tax and financial consequences on your IPO.

This includes:

- Address material income or transaction tax issues prior to the offering
- Set appropriate policies, procedures, and internal controls to meet tax compliance and reporting requirements as a public company
- Accurately state and support your tax positions

While your tax due diligence should not be limited to the following items, identifying and addressing tax expense and exposures related to each of these items is a good start.

1. Put financial statements in order

Resolve any outstanding financial issues prior to going public. Every effort to minimize tax risk and uncertainty staves off performance concerns in the lead up to and the immediate aftermath of the IPO. *How a company addresses tax expense is an important determination for prospective investors.* Items like financial restatements and internal control material weaknesses could be red flags for investors that handicap your IPO out of the gate. The IPO execution team should look closely at the company's existing functionality around accounting systems, stated tax positions, and filed tax returns as well as assess the availability, accuracy, and timeliness of tax information used for financial reporting.

Carefully review both the company's current tax provision calculations (or prepare initial calculations if no provision has ever been prepared) and federal and state income tax returns the year prior to IPO-due diligence work. If the relevant tax expertise does not exist in-house, consider engaging an outside tax provider for assistance.

2. Analyze legal entity structure

Many closely held businesses are operated as flow through entities for tax purposes and structured as LLCs treated as partnerships for income tax purposes (partnership/LLCs) or Subchapter S corporations. Either prior to going public or as a result of an IPO transaction, these entities typically convert to a C corporation. There are situations where **incorporation could cause an immediate taxable event upon formation**. Consult with your tax adviser to carefully plan for:

Incorporating a partnership or LLC
Managing built-in gains tax and the distribution of S corporation earnings prior to conversion from an S corporation to a C corporation
Addressing the allocation of tax items to the pre-and post-incorporation periods from both a tax provision and a tax return perspective
Evaluating final short period return filing requirements; filing of returns for the newly-formed entities; and amounts and timing of any estimated tax payments that may be required for the newly formed taxable entity or entities

3. Identify uncertain tax positions

Private companies typically prepare their income tax provision once a year, if at all, whereas public companies are required to do so quarterly in a time and resource intensive process. Whether it is a particular tax deduction taken or a decision not to report revenue in a particular period, financial statements only reflect a tax position that is more likely than not to be sustained if challenged by a taxing authority. **Tax provisions could equal as much as 35% to 40% of a company's net income before tax**, though the percentage can swing significantly. Discovering an uncertain tax position post-IPO can lead to significant fluctuation in the effective tax rate. Other negative implications are the possible restatement of prior financial reporting.

In preparation for public company reporting requirements, businesses should perform a thorough review of tax positions taken on prior year's tax returns to determine if any are uncertain under a "more likely than not" criteria and take the necessary steps to address and document such positions pre-IPO.

4. Analyze deferred tax assets and liabilities

Many private companies structured as partnerships, LLCs, or S Corporations may not have calculated their deferred tax assets and liabilities. **Conversion to**

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a C corporation creates the need to establish deferred tax assets and liabilities. To help prepare for reporting as a public company, a business should:

Substantiate that deferred tax asset and liability positions are supported by differences in book and the tax bases of balance sheet items

Substantiate deferred tax assets related to net operating losses and credits, including any potential limitations as a result of ownership changes (See item 6)

Review net deferred tax asset under a "more likely than not" criteria and record any valuation allowance, reducing the amount of asset reported

Changes in a company's deferred tax asset position may be made when a tax law is enacted. For example, if policymakers were to lower corporate tax rates, the rate change could result in a significant adjustment to the amount of deferred tax assets and liabilities reported on a company's balance sheet and income tax expense reported on the income statement. Any changes in tax law could have a significant impact on deferred tax assets and liabilities.

5. Mitigate tax return filing exposures

State nexus issues, where a company has created a filing requirement but failed to file a tax return, are a classic tax exposure for companies going public. Private businesses that elect to file tax returns in one state but have property and sales or other nexus creating activities taking place in multiple states are **exposed to potentially difficult-to-manage tax situations**. Similar exposure exists for international activities. Businesses will want to address proper filings of tax returns in relevant jurisdictions in advance of going public.

State tax laws may provide opportunities to file prior year returns under voluntary disclosure arrangements, which allows the company to mitigate the state tax exposure and reduce any potential penalties related to previously unfiled returns.

6. Evaluate net operating loss carryforwards and other tax attributes

When an ownership change occurs as a result of a stock issuance or sale, certain sections of the tax code may result in the amount of net operating losses and other tax attributes being severely limited and the value to the company reduced. This is particularly true with net operating losses that may be carried forward 20 years and carried back two years, which would otherwise be available to partially or fully offset income earned in those years. If the IPO results in a cumulative ownership change of greater than 50 percent during a three-year period, **net operating loss or credit carryforwards may be partially or fully restricted from use.**

Businesses that anticipate a significant change in ownership should look for opportunities to make full use of the net operating losses in advance of a public offering. In addition, the timing of the IPO can have a material impact on the calculation of the cumulative ownership change and should be considered.

7. Assess non-income tax considerations

The following non-income tax areas should also be assessed prior to an IPO.

- Sales taxes on company product or services
- Use tax liability on company purchases
- Personal property tax renditions upon filing, and accompanying accrual of tax liability
- Real property tax
- Stock transfer taxes
- Transfer pricing and other intercompany agreements
- Tax consequences and opportunities associated with the use of IPO proceeds

8. Build an independent tax team

The leading causes for tax-related material weaknesses and restatements is the lack of trained personnel and management review. Tax advisers should be an integral part of the IPO execution team to **assess potential tax implications of a new corporate structure** and minimize adverse tax consequences of going public to the company and its shareholders.

Establish an independent, qualified tax team to, at a minimum:

- Create an appropriate tax structure for a public company with tax controls, financial disclosure procedures, and an appropriate reporting environment
- Address material income or transaction tax issues that could lessen the success of the IPO prior to the offering
- Assess change in accounting methods opportunities that may exist upon incorporation
- Implement a tax provision process
- Assess the expected tax implications of the planned use of IPO proceeds
- Source personnel and implement processes for meeting tax obligations as a public company prior to filing
- Consider tax consequences of incentive compensation and restricted stock
- Develop a governance structure incorporating tax strategies into business and financial decision making as a public company

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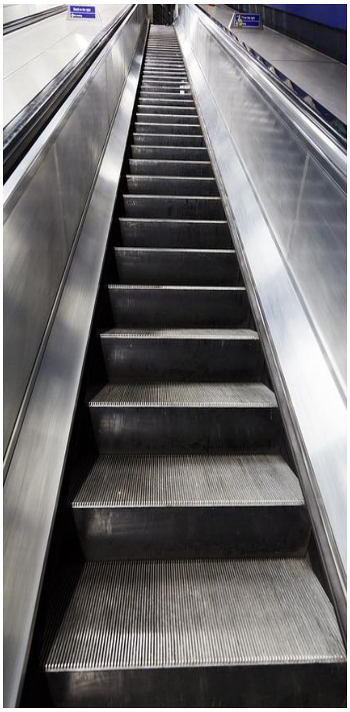
Advance preparation

Not every IPO is a success. But by presenting your company's financial position in the best light, you'll increase the chances that your IPO does reach its potential. Cleaning up financial statement and disclosure issues in-house, and in private, before going public is a critical step. Companies should aim for a clean bill of tax health and a tolerable level of tax risk when preparing to go public.



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