

Transition services agreements – not just for unrelated parties

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Introduction

Many triggers can prompt companies to change their operating models, such as acquisitions, divestitures, legislative or regulatory actions and operational changes. These triggers may lead to transitions that often result in complex and lengthy transformation programs. During this period of change, companies require a framework to facilitate the continuity of essential services. Such services may encompass back-office functions, including tax, accounting and legal support, as well as operational areas, such as procurement, logistics and manufacturing. This arrangement typically takes the form of a transition services agreement (TSA). A TSA is a contract between two parties that outlines the terms under which the seller will provide specific essential services to the buyer for a defined period following the completion of the transaction.

TSAs are commonly used between unrelated buyers and sellers in acquisitions and divestitures to manage operational disruption and financial risk by clearly defining, among other issues, the scope of services involved, associated remuneration, the term of the arrangement, the costs and risks borne by each party, and communication and escalation protocols. Although less commonly seen, they can also be used for many of the same reasons between related parties during internal restructurings and operating model changes. The agreement explains the intent of the parties and can help support the appropriateness of journal entries, service fees and profit allocation between entities. A TSA can be a valuable tool for explaining the economic framework of the transition to the new model, particularly since governments often intensify their scrutiny of profit allocation between related parties.

Companies should assess the business benefits, practical considerations and accounting and tax issues before entering into such an arrangement – whether between unrelated or related parties. While there may be important nuances, and those considering such an agreement should consult with legal counsel, in this article we endeavor to demonstrate that a TSA can be used in both situations to provide more consistency and clarity during operating model transformations.

TSAs in action

Between unrelated parties

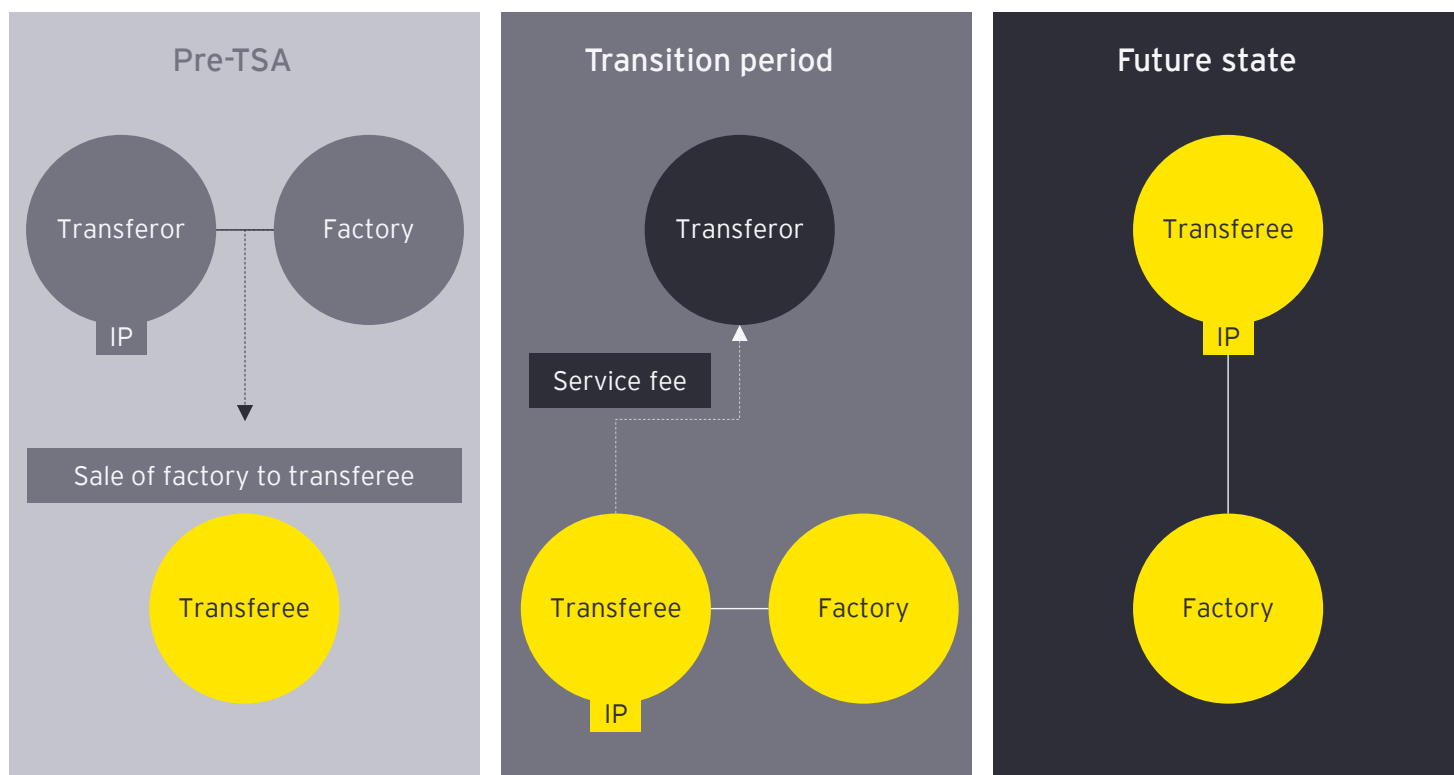
Assume the buyer purchases a division of the seller's business, including a factory, but the buyer's enterprise resource planning (ERP) system will not be ready to record financial transactions (such as buying materials, tracking inventory and selling products) for several months. To accommodate the gap in buyer's ERP system readiness, the buyer and seller sign a TSA, under which the seller will continue to operate the business and the factory as a transition service to the buyer. The seller knows the operations (such as suppliers, customers, order management system and business processes) and, under the TSA, the business can continue with minimal disruption until the buyer's ERP system is ready. Since the buyer owns the business during the TSA period, it has the benefits of the business profits and the burdens of the relevant business risks as agreed in the TSA.

Between related parties

Consider a global manufacturer (GlobalCo) that purchased a business with several factories from a third party. GlobalCo refers to the purchased business as Business Unit Gold (BU Gold). BU Gold headquarters, including intangible property (IP), leadership and daily management, are located in Country A. Several years later, GlobalCo decides to simplify its operating model by collocating key leaders, reducing transactional flows and harmonizing IT systems. Under this plan, GlobalCo will move BU Gold's headquarters from Country A and combine it with Business Unit Blue (BU Blue) headquarters in Country B. BU Gold's IP and key leadership functions will eventually move to Country B. In addition, BU Blue's IT systems must be upgraded to accommodate BU Gold's business operations.

GlobalCo has received a ruling from Country B's business development authority to receive certain financial and nonfinancial incentives effective immediately. However, it will take GlobalCo nine to 12 months to complete the transition, including implementing the required IT systems. Although executives must be transferred, newly hired or legacy Country B roles modified, finalizing the organizational design can be accomplished in several ways. The time it will take to design, program, test and implement the IT systems to accommodate BU Gold's operations is less flexible. If GlobalCo is going to avail itself of its agreement with Country B's government, it must be able to report BU Gold's business results in Country B sooner than the IT upgrade timeline will permit.





- Prior to the transfer, the transferor managed the factory.
- The transferee purchases the factory but needs time to integrate its operations into their business structure.
- The transferor will oversee factory operations until the transferee fully integrates them, receiving a service fee in exchange.
- Profits from the factory's product sales will be recorded in the transferee's financial statements.
- The factory's operations are completely integrated with the transferee's operations.
- The transition services agreement between the transferor and transferee has ended.

Both the unrelated and related party scenarios involve operating model integration. The overarching issues, analytical details and risk considerations will be similar, albeit nuanced between the two scenarios. A TSA may be appropriate in both situations to facilitate a smooth transition into the future states. For the convenience of discussion, we will use the terms "Transferor" and "Transferee" to denote the two key parties in the TSA arrangement, regardless of whether they are related or unrelated, and without regard to the specific form of transaction.

Business benefits

A TSA may effectively manage the complexities and risks associated with business transitions, helping to ensure a smoother and more efficient process for both parties. Benefits, which may vary in importance between related and unrelated scenarios, may include:

- **Operational continuity:** The transferor continues to operate the acquired business without interruption while the transferee has time to establish its own systems and processes.
- **Knowledge transfer:** The parties gain additional time to pass best practices and expertise from the transferor to the transferee's management team.
- **Transition management:** The transferee obtains the necessary time to plan and implement its own systems and processes in a structured manner.
- **Regulatory compliance:** The business remains compliant with regulatory requirements during the transition period.
- **Customer and supplier relationships:** Existing customer and supplier relationships are maintained by ensuring that service levels and contractual obligations are met during the transition period.
- **IT systems and infrastructure:** The transferee retains access to IT systems and infrastructure while developing its own capabilities.
- **Operational flexibility:** Both parties benefit from flexibility – the transferee can focus on integration and growth while the Transferor can gradually wind down its involvement in the divested business.
- **Accelerated transaction close:** The parties may be able to use this tool to close a transaction on an accelerated timeline despite pending administrative matters and save transaction costs associated with sign-to-close duration.

Practical business considerations

A TSA requires clear guidelines to facilitate a smooth and efficient transition between the parties. Unrelated parties negotiate terms based on their own approach and the details matter. TSA details are often agreed upon during the period between when a deal is signed and when the transaction is closed. Business strategy and the TSA details also matter in the context of a related-party scenario. These and other practical business considerations should be reviewed and discussed with management and legal counsel.

The agreement should still be concluded before executing the transformation. Both related and unrelated parties may consider several factors to effectively design and administer a TSA, such as:

- **Duration and scope:** The TSA should clearly define the duration and scope of the services to be provided. This clarity is essential for determining the financial, accounting and tax implications of the agreement.
- **Employee transfers and retention:** Determining which employees will transfer to the Transferee, which will remain with the Transferor and those involved in the TSA is essential. This involves identifying key personnel, how they will operate and the service levels between the parties.
- **Communication and change management:** Providing clear and consistent communication to employees about the transition process, timelines and any changes to their roles or employment terms is critical for business continuity and a successful TSA.
- **Service level agreements (SLAs):** Implementing SLAs is crucial to help establish that the services are provided at the agreed-upon standards. These agreements can significantly impact the valuation and accounting treatment of the services.
- **Exit strategy:** A well-planned exit strategy for terminating the TSA is necessary. This includes transitioning the services to the Transferee's internal resources or third-party service providers for a smooth and efficient handover.
- **Regulatory compliance:** Compliance with all relevant regulatory requirements, including antitrust laws and industry-specific regulations, is mandatory. This helps establish that the TSA adheres to legal standards and helps avoid potential legal issues.
- **Documentation:** Maintaining thorough documentation of the TSA is vital. This includes detailing the terms, pricing and rationale for the arrangement, which is important for both tax and accounting purposes.

Accounting considerations

TSAs involve complex accounting implications, particularly when the Transferor continues to invoice the customer on behalf of the transferee. The TSA document, accounting theory, journal entries and financial statements must all align to support the intent and substance of the arrangement. This alignment is equally important for both related and unrelated scenarios. Accounting matters require careful analysis and consideration when designing and operationalizing a TSA. For example:

- **Revenue recognition:** When one party (the transferor) operates the business on behalf of and for the benefit of another party (the transferee), one must assess which party in the scenario should recognize the business's revenue and expenses. In general, the party that controls the goods or services before they are sold to the customer should recognize revenue on a gross basis along with the related costs.

TSAs are often used when the transferee requires time to prepare its ERP system to accommodate the new business's activities. Procurement, production, inventory, order management and sales may be recorded on one party's system but economically belong to the other party. Such activities would need to be reversed from the transferor's financial ledgers and recorded in the Transferee's financial ledgers through manual journal entries. Additionally, a detailed analysis of the factors that establish such control should be performed to avoid incorrect reporting of revenue and profits related to the business.

- **Inventory:** While the assessment of inventory is often interrelated with the assessment of revenue, there are differences, particularly when the parties are selling to each other rather than solely to third parties. Even in related party or common control TSAs, transfer pricing issues can be particularly relevant, and contracts or internal pricing mechanisms may be intended to coordinate with legal, tax and import/export duty or tariff obligations.
- **Leases:** Such arrangements may involve embedded leases – intentionally or unintentionally. Companies should assess whether TSAs contain embedded lease arrangements and, if so, whether any sale-leaseback guidance applies. Certain types of leases can fundamentally alter the accounting for the original transfer and for the TSA.



Accounting considerations (cont'd)

- **Consolidation:** Transactions that give rise to TSA arrangements may involve dedicated legal entities, which may need to be evaluated for consolidation, even if one party does not have equity in the other. These assessments can be complex and may affect whether the initial transaction, or some portion of it related to the dedicated entity, is recognized as a transfer.
- **Cross-functional alignment:** Designing TSAs that align with the desired accounting outcomes for both the Transferee and the Transferor, while being tax-efficient and legally permissible, requires effective coordination across accounting, tax and legal functions.
- **Reporting process alignment:** The financial reporting process of both transferee and transferor becomes entangled due to reliance on the Transferor's provision of financial information in time for the Transferee's reporting of the business.
- **Statutory reporting:** Local statutory reporting for TSAs may differ from consolidated reporting, and accounting operationalization would need to address dual accounting frameworks. Additionally, while related party arrangements between legal entities of a controlled group may eliminate consolidated reporting, local reporting requirements may still drive accounting complexity.

Tax considerations

While the business benefits of TSAs are considerable, several tax issues should be evaluated to help reduce the potential direct and indirect tax costs of operating a TSA. If the TSA is established between unrelated parties, tax matter provisions or indemnification clauses in the transaction typically determine how such issues are handled. If the TSA involves related parties, tax matters may be addressed through internal processes and may include:

- **Payment characterization:** Payments made under a TSA can be characterized in different forms, such as service fees and purchase price consideration. The characterization affects the tax treatment of these payments and their deductibility.
- **Expense deductibility:** The transferee needs to determine whether the payments made under the TSA are deductible for tax purposes. This depends on the nature of the transaction, the entities involved in settling the payments (which may be different from the service provider and recipient) and local tax laws.
- **Value added tax (VAT) or goods and services tax (GST):** The provision of services under a TSA may trigger VAT or GST liability. The parties need to determine the correct VAT or GST treatment and comply with local regulations. Designing a TSA with VAT or GST as a key tax consideration is critical to help reduce unrecoverable indirect taxes.

- **Withholding taxes:** Payments made under a TSA may be subject to withholding taxes, especially in cross-border arrangements. The applicable tax treaties and local tax laws need to be considered to determine the correct withholding related to these payments.
- **Transfer pricing:** If the TSA involves cross-border transactions between related parties, the services provided under the arrangement should be conducted at arm's length.
- **Permanent establishment:** The provision of services by the Transferor in the Transferee's jurisdiction may create a permanent establishment, depending on the nature of the services performed, leading to additional tax obligations.



Conclusion

- TSAs can play a significant role in achieving a smooth transition between the current and future states of internal business transformations, just as they do between two unrelated parties in the sale of a business. A well-drafted TSA, designed and executed by legal counsel, may help a company explain the overall economic and legal construct of the transition period when dealing with vendors, customers and lenders who need to understand the arrangement for their own purposes. The agreement will also help governments understand the substance of the arrangement when they scrutinize financial statements, cash movements and tax filings and positions. As businesses continue to evolve and adapt to changing market dynamics, the importance of a well-crafted TSA cannot be overstated. A TSA can serve as an important tool for achieving successful outcomes in corporate transactions, both external and internal.

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