

Legal entity reduction: Savings on tap?

Perhaps few other corporate planning opportunities better embody the concept of “less is more” than legal entity reduction. At a time when many multinational companies are still recovering from the effects of the global economic turmoil and aggressively seeking ways to grow the top and bottom lines, legal entity reduction offers a compelling proposition: simplify operations, reduce redundant systems, processes and personnel, and – above all – pursue potential savings that are sustainable over time.

This article highlights the practical reasons for legal entity reduction, as well as leading practices and potential pitfalls for companies undertaking this type of rationalization, and offers suggestions for approaching a legal entity reduction initiative more effectively.

The compelling case for legal entity reduction

As businesses grow, particularly through mergers and acquisitions, the number of legal entities comprising the business often grows as well. Many large multinational enterprises are home to hundreds of legal entities, many of which are duplicative, essentially inactive or underutilized, and, therefore, represent unnecessary costs and resource consumption.

It does not take a large number of acquisitions to accumulate too many legal entities. For example, a company that undertakes several acquisitions over a multi-year period without corresponding legal entity rationalization could end up with many more legal entities than it anticipated or needs. Each acquired company could have its own series of duplicative companies, resulting in overlapping entities that do not make sense to maintain.

Smaller organizations are no less prone to excessive legal entity burdens. One recently encountered example involved a company that had a total of only 24 legal entities, but that was approximately 20 too many. Because of system limitations, the company was forced to maintain their separate company accounting records on those legal entities in the tax department on spreadsheets. This approach not only created extra reporting risk, but it was highly inefficient from a tax perspective because losses were being stranded in legal entities that it had no way to consolidate.

Multiply these inefficiencies and risks by dozens, and possibly hundreds of extra legal entities, and it becomes apparent how redundant activities, costs and compliance risks can quickly expand across an enterprise in the following key areas.

Accounting costs – Reducing the number of legal entities can lower the costs associated with maintaining legal-entity accounting records. One of the largest savings areas can be in the time and resources that are devoted to intercompany balance reconciliations each month.

Tax department – Taking the U.S. as an example, many U.S. multinational companies manually prepare and file their Forms 5471 (Information Return of U.S. Persons with Respect to Certain Foreign Corporations). When this involves hundreds of legal entities, the required compliance process can consume the time of many professionals in the tax department each spring, summer and fall without creating commensurate value in terms of savings or planning. How much additional value might be created if the energy and time of these individuals could potentially be reallocated to other more important work if legal entity reduction resulted in fewer Forms 5471 needing to be completed? Moreover, given the recent changes to Internal Revenue Code section 6501(c)(8) (which provides an exception to the general rule that taxes are to be assessed within three years after a taxpayer’s return is filed), U.S.-based companies should be highly motivated to reduce compliance risk related to filing of information returns, lest they result in the inadvertent and unexpected extension of the statute of limitations.

Customer and employee data – Data privacy is a major issue for any business, but especially for multinationals, which must address the widely varying privacy requirements of countries around the world. By eliminating unnecessary legal entities, companies may find that it is easier to assimilate, maintain and control their customer and employee data in compliance with legal statutes and regulatory requirements.

Supply chain – As a business matter, supply chain planning has probably garnered more focus and attention than almost any area other than governance. While the benefits of sourcing and inventory management can be significant, the dark side of supply chain planning is the legal entity complexity that it can sometimes require. While business and tax planning related to the supply chain can sometimes place functions, compliance risks and revenue into legal entities in tax-efficient locations,

the complexity arising from the numerous legal entities, required intercompany agreements and accounting has potential costs that need to be weighed against possible tax benefits. Can similar global tax benefits be pursued with an operations profile that has been streamlined through legal entity reduction? Can the current level of benefits be increased?

HR, talent management and payroll – Complex multinational businesses with many legal entities must also address the management of multiple human resources responsibilities, personnel development programs, pension plans, payroll registrations and countless other activities relating to the workforce. A wide variety of programs can be streamlined and improved through legal entity restructuring to pursue cost savings.

Treasury – At a very basic and practical level, each operating legal entity must have at least one (and often several) bank accounts. Every bank account represents a monthly maintenance fee, cost of employee daily oversight, as well as potentially daily cash sweep fees, which can often be reduced through legal entity reduction (which reduces the number of outstanding bank accounts). Also, many controlled foreign corporations (CFCs) act as guarantors or have their stock pledged. If the number of those CFCs can be reduced and the guarantee be issued by a single CFC or by a single top holding company, it might make it easier for the company to comply with and manage debt covenants in complex, cross-border situations.

Potential for savings – What kind of savings can potentially be gained from legal entity reduction? Certainly, results will vary from company to company, and duplicative operating companies hold more promise for savings than do dormant companies. Let's consider two examples of legal entity reduction initiatives:

- Company A is a complex multinational business with many product offerings across a very diverse customer portfolio. This diversity has created an incredibly complicated legal structure with many different supply chains and an even greater number of intercompany transactions. Through careful study, the company concludes that its cost for maintaining those legal entities totaled USD 250,000 per entity, per year. By undertaking a legal entity reduction program targeting 20 legal entities, the company estimated it would save USD 5 million annually on a recurring basis compared to the status quo.
- Company B takes a different approach. This company assigns a professional from its tax department to lead a legal entity reduction program, and management gives that individual a metric to achieve: USD 3 million in annual cost savings. In the assessment phase of the program, the company determined that it only had to eliminate 12 legal entities to achieve that USD 3 million metric.

Each company may approach legal entity reduction differently, but the results can be beneficial, not only in terms of annual cost savings, but also in terms of improved operational efficiency and risk management.

Approaching the legal entity reduction process

The first major hurdle companies face when initially considering legal entity reduction is where to start the process. Who should lead the initiative? How many people should be on the team? From which departments should those people come?

Companies may feel that the corporate tax return is the logical starting point for legal entity reduction, which should contain a list of all legal entities. In fact, tax returns are sometimes prone to understatement in terms of the number of legal entities, often omitting dormant entities and other outliers. Instead, a better approach generally involves starting with the corporate secretary or someone in the legal department who has a legal entity register – the official list of corporate legal entities that should be most up to date and accurate.

A leading practice in major companies is to identify the individuals who have specific domain knowledge about key aspects of the operations, including professionals from accounting, finance, HR, IT, legal (including environmental), supply chain and tax. No one person or department – international tax, for example – should undertake a legal entity reduction initiative alone. What may look like a perfectly logical plan from a tax perspective may make no sense whatsoever to the legal, HR or IT departments, given their unique perspectives on risks and costs. Instead, a tight-knit, cross-functional team whose members have deep knowledge of different areas of the enterprise is more likely to see the big picture and identify opportunities and pitfalls.

Once the team is assembled, important next steps include:

- **Establishing the foundation and framework** – At the outset, the team needs to build the business case for the initiative – identify potential areas of opportunity, define goals and develop metrics that will either guide the decision-making or define the success of the project.
- **Collecting data** – The team needs to gather information that presents a clear picture of each legal entity to be considered for elimination. Are there particular legal entities that might contain “black hole” environmental, product or other liabilities that could drag down other legal entities? Where are potential tax losses? Are there any European entities that could give rise to works council issues? Are there legal entities that cannot be changed under any circumstances, for instance, because they have issued public debt or have critical nontransferable licenses? While dormant legal entities are easy targets for rationalization – easy to find and eliminate, and giving the illusion of fast progress by slimming down the organization chart – savings from the elimination of dormant entities may not deliver the same kind of business and operations alignment as might be possible with other legal entity reduction opportunities. For example, a company may eliminate 25 dormant entities but only save a few thousand dollars a year, while the elimination of overlapping operating companies could provide much larger potential savings. Building profiles that consider these and many other issues via appropriate cross functional due diligence is a critical foundation.
- **Developing options** – This is a brainstorming stage during which the team has the chance to explore many different legal entity reduction alternatives and outline the benefits and challenges of each. A leading practice is to ensure the ultimate list is narrowed down to options that align most favorably with the overall business strategy. For example, a plan to combine multiple manufacturing operations – each owned by a different entity – might be accomplished in several ways. It is possible to pursue both the operating or business goals with a tax-aligned plan after a few iterations, but multiple scenarios can and should be evaluated.
- **Implementing the plan** – With options identified, the team needs to develop a detailed implementation and communications plan, assemble the implementation team, communicate to stakeholders and execute the plan. Planning and preparation can take months, but the upfront effort to achieve alignment is critical to a successful implementation.
- **Measuring the results** – Companies often worry that they will undertake legal entity reduction initiatives only to have new entities sprout up when new M&A strategies are carried out – certainly a consideration as companies move into the next economic growth cycle and M&A activities pick up. One leading practice is to put in place a robust, cross functional legal entity approval process, whereby a committee or team reviews and approves the formation of any new legal entities. This will not necessarily prevent legal entities from arising through M&A activity, but it can prevent unnecessary organic growth of legal entities and help a company keep better tabs on the overall structure of the enterprise.

Implications for international tax practitioners

Although a tax professional probably may not be the best person to lead a legal entity reduction project, the tax department – international tax, in particular – should be engaged in the process from the outset. These projects represent an opportunity for international tax practitioners to explore tax planning options and manage any potential hazards.

A company-wide simplification initiative is a major business change, and it may be connected with a broader reevaluation of product portfolios, go-to-market strategies, finance transformation or customer segmentation. As with most major business transactions, there are potential tax consequences to be understood and investigated. By reviewing raw data about the legal entities being considered for rationalization, tax professionals can begin to build out the “tax DNA” of each entity, understand specific tax attributes that are relevant for planning and even begin refreshing tax attributes for tax planning purposes. Raw data may include tax attributes such as earnings and profits, foreign tax credits and basis, as well as intercompany loans, IP ownership and function or role in a given supply chain. This data can be used to compile the best possible profile for each legal entity, along with a keen understanding of how up to date and accurate the information is.

Also, as the team works on identifying legal entities to be eliminated, tax questions will arise: Can we reduce withholding taxes and improve treasury efficiency by aggregating subsidiaries into a single holding company? Can we merge a loss entity with a profitable entity to utilize operating deficits? Should we execute an intercompany sale of entities to push debt into country entities and improve local tax efficiencies? This is an optimal time to address these questions and look for ways to pursue more tax-efficient operations even as the number of legal entities is being rationalized.

A final opportunity involves streamlining tax operations. By eliminating some legal entities, a company can reduce financial and tax reporting obligations in a meaningful way and redeploy the resources previously required to meet those obligations.

Possible tax pitfalls to consider

The potential ramifications of not involving the tax department in a legal entity reduction project may include:

- Triggering local country gains or limiting local country losses;
- Moving assets from branch structures in an effort to liquidate them, thereby triggering for U.S. purposes remittances that have section 987 (relating to foreign currency) gains and losses associated with them;
- Movement of financing entities resulting in the creation of an actual loan for U.S. purposes that was previously treated as a disregarded entity; and
- Moving inventory rapidly from one group to another and inadvertently creating a value added tax or customs liability.

By having the tax department involved in the project from beginning to end, many of these issues may be addressed before they become problems.

Keeping the end in sight

Legal entity reduction initiatives are not usually quick or easy. To anticipate as many challenges as possible and increase the chance of success, companies should engage individuals on their team who clearly understand the vision – not just the vision of what the organization will look like, but also what the benefits of legal entity reduction can potentially be.

Then, as the team is built, make sure all stakeholders across the organization understand what is in it for them. Communicating the benefits will be critical: Why will this group or that function be better off? How can they save costs in their own organization for the benefit of the whole company?

Next, align the effort with the way the business works. Doing so will reduce friction across the organization when decisions need to be made. It will also enable a logical and phased approach so the team can work on the project one piece at a time without being overwhelmed.

Finally, it is important to take measured steps and record results at all stages of the project. Were the goals achieved? Is the enterprise better off because of the initiative?

Concluding thoughts

Legal entity reduction is a team sport. While tax is an important element, it cannot be the only element or even the most important element in the process. Success is ultimately achieved when the business and support functions of an enterprise work together to accomplish the goal. The outcome of such a cross-functional effort is a legal entity structure that is both consistent with the business operating model and less expensive to maintain.

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