Let’s Be Rational Here: Tax Considerations in Legal Entity Rationalization

Eric Tresh, Partner
Robb Chase, Partner

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Overview

I. Why be Rational?: Reasons for Legal Entity Rationalization
II. Internal Restructuring
   A. Tax Considerations
   B. Recent Trends
III. Implementation Process
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Overview: Why be Rational?

- A typical business life cycle leads to business complexity
- Business complexity begets increased costs

Benefits:
- Structural Simplification
- SG&A Efficiencies
  - HR/Payroll
  - IT
  - Operations
  - Legal & Regulatory
- Corporate Alignment
- Tax Efficiencies and Savings
Overview: Internal Restructuring

- **Tax Considerations**
  - Ensure legal entity rationalization is tax efficient and the tax cost of implementation is minimized
    - Remember:
      - State does not always follow fed
      - Consider overlay of international rules

- **Eliminate structural tiers or redundant entities within corporate structure**

- **Utilize and monetize trapped losses**

- **Utilize other tax attributes**

- **Optimize combined or consolidate group and state specific rules**

- **Utilize LLCs over corporations**

This communication cannot be used for the purpose of avoiding any penalties that may be imposed under federal, state or local tax law.
Overview: Implementation Process

- Project Evaluation Process
  - Consider business needs, objectives, and/or limitations
  - Perform a review of each legal entity to understand any business concerns and/or tax issues
  - Consider the impact of outsourcing
  - Review the federal, state, and international income/franchise tax posture of the legal entities
  - Understand tax attributes of each entity
  - Consider state transaction tax costs – e.g., sales, real estate transfer, and gross receipts taxes

- Implementation in stages facilitates management of process and allocation of internal and external resources

- Rationalization requires full corporate, legal, and business support
I. Why be Rational?

Be Rational

Get Real

MATH JOKES
If you get them, you probably don’t have any friends.
Why be Rational?

- A typical business life cycle leads to business complexity
  - Organic Growth
  - Inorganic Growth
  - Special Purpose Entities
  - Regulatory and Licenses
  - Isolate Risks

- Business complexity leads to increased costs
  - Decentralized operations and management
  - Decentralized and unprotected intellectual property
  - Increased regulatory and compliance costs
  - Increased time on internal controls
  - Greater audit risk
  - Slow to change and slow to market
“Companies with a high number of legal entities have finance costs that are almost double those at companies with a low number of entities.”

Benefits: Although there can be significant tax benefits, there are potentially more significant non-tax reasons to be considering legal entity rationalization:

- Structural Simplification
- SG&A Efficiencies
- Corporate Alignment
- Tax Efficiencies and Savings
Why be Rational?

Structural Simplification

- Simplify organizational structure to eliminate dormant, inactive, duplicative, and otherwise unnecessary entities
- From a tax perspective, structural simplification can minimize the company’s tax footprint and reduce the risk that transactions result in unanticipated tax costs
Why be Rational?

SG&A Efficiencies

- **HR/Payroll:**
  - Time savings associated with aligning the structure to match the pension, 401(k) plans;
  - Health and welfare and retirement plan consolidation; and
  - Simplification of filing obligations

- **IT:**
  - Reduce costs related to the company’s information technology costs, financial account fees, and accounting expenses

- **Operations:**
  - Eliminate duplicate operational services among the entities, regulatory filing fees, and record maintenance expenses; and
  - Reduce costs associated with related party transactions, and simplify debt and equity funding
Why be Rational?

SG&A Efficiencies (cont’d)

- Legal and Regulatory:
  - Reduced time and costs associated with duplicative licensing, permitting, and regulatory filing cost
  - Reduced costs associated with record maintenance
  - Savings of time expended by Board of Directors attending annual meetings and meeting with statutory formalities
  - Reduced time and related costs associated with the preparation and filing of public notices
  - Savings associated with elimination/consolidation of registered agents in applicable jurisdictions
Why be Rational?

Corporate Alignment

- Align corporate organizational structure along business segments or reporting lines
  - Creates more transparency for profit and loss statement
  - Aligns corporate organizational structure with accounting and tax compliance and reporting

- Facilitates identification and management of risk within the group

- Aids in the consolidation and management of financing arrangements

- Streamline cash management within the structure
Why be Rational?

Tax Efficiencies and Savings

- Reduce and minimize filing requirements
- Use of conversion and elimination transactions to maximize deductions
- Identify and eliminate stock DITs
- Efficient use of U.S. and non-U.S. tax attributes
  - Identify and preserve net operating losses ("NOLs") for future usage
- Facilitate efficient intragroup financing and international earnings repatriation
- Ensure current and anticipated structure take into account U.S. and OECD international tax reform proposals
II. Internal Restructuring

“We’ve reorganized so many times we are now one of our own subsidiaries.”
Tax Considerations

- Ensuring that legal entity rationalization is tax efficient and minimizing the tax cost of implementation is important
  - Liquidations, mergers, and legal entity conversions can be used to facilitate rationalization objectives, while minimizing tax costs – See Appendix
  - Care should be taken to avoid taxable distributions under § 311(b)
    - Although taxable transactions among U.S. entities may be eliminated in consolidation for federal tax purposes, there can be significant state tax consequences
  - Consider application of § 304 with respect to stock sales – deemed contribution and redemption
  - Carryover of attributes under § 381 – review state specific rules
  - Application of SRLY limitations
Internal Restructuring

Tax Considerations

- If international businesses or operations are involved, important to consider overlay of international rules:
  - § 367(a) and (b) – Gain recognition agreements may be required for outbound transfers
  - Dual consolidated loss rules
  - Overall foreign loss rules
  - Foreign branch loss recapture
Internal Restructuring

Tax Considerations

- Eliminating structural tiers or redundant entities within corporate structure
  - Reduce potential taxable events triggered by intercompany transactions
    - Transfer pricing considerations
    - Intercompany financing arrangements
      - Ensure that intercompany obligations are properly treated as debt for tax purposes
      - Consider limitations on deductibility from a federal or state perspective
    - Caution: make sure that entities slated for liquidation files for withdrawal in those states where it files returns before liquidating
Internal Restructuring

Tax Considerations

- Utilization and monetization of trapped losses
  - Consider state specific law on NOL utilization
  - Federal conformity

- Utilization of other tax attributes
  - Tax Credits
  - Carryovers
  - Basis considerations

- Improve financing/borrowing power
  - Factoring
  - Debt realignment
Internal Restructuring

Tax Considerations

- Optimize the combined or consolidated group
  - Better align with federal consolidated return; or

- Optimize based on state specific rules regarding composition of the reporting group
  - Nexus-Consolidated return
  - Nexus-Unitary combined return
  - Joyce/Finnigan considerations
  - Pre- or Post-apportionment consolidation?
Internal Restructuring

Tax Considerations

- Optimize tax treatment of intercompany transactions in separate reporting states
  - Deductions for interest expenses, royalty/licensing fees
  - State add back statutes and exceptions

- Reduce nexus risk
  - Sales tax
  - Income or franchise taxes

- Reduce duplicative tax filings
  - Reduce administrative costs, tax compliance burden, and stewardship expense
Internal Restructuring

Recent Trends

- Utilization of LLCs over corporations
  - Use of limited liability companies ("LLCs") may not reduce the number of entities in the group, but can achieve tax simplification where entity elimination is not possible
  - Business entity classification regulations, entity either treated as corporation or as a pass-through entity
    - Per se entities – incorporated entities
    - An unincorporated domestic entity is generally an “eligible” entity
    - If no affirmative election filed, default classification of domestic eligible entity: partnership or disregarded entity
Recent Trends

- **Utilization of LLCs over corporations (cont’d)**
  - Classification regulations provide the tax consequences of elective changes in classification
    - If entity that is treated as a corporation elects to be treated as a disregard, deemed liquidation
    - If deemed liquidation into an 80% distributee, it is a §§ 332/337 liquidation
Recent Trends

- Utilization of LLCs over corporations (cont’d)
  - Conversions often not effected via elective change in classification
    – conversions often effected by filing certificate of conversation or by merger of corporation with an into an LLC
  - Look to the deemed transactions in the entity classification regulations for tax analysis
  - IRS has relied upon the deemed transaction sequence in entity classification rules for a formless conversion (by filing a certificate of conversion)
  - Formless conversion of a corporation (or merger into an LLC) should be treated in the same manner as if an elective change had been made
    - Corporation deemed to have distributed assets and liabilities in liquidation
Recent Trends

- Utilization of LLCs over corporations – Two primary methods:
  - (1) **Statutory Conversion**
    - A majority of states allow a corporation to convert directly to a LLC
    - A separate LLC need not be formed before the conversion can occur
  - Procedural steps:
    - Board approval and/or adopt plan of conversion
    - File Certificate of Conversion and Articles of Organization
  - Treated as nontaxable event; appears as a name change to many taxing jurisdictions, customer and vendors
Internal Restructuring

Recent Trends

Statutory conversion authorized by state law to offset parent company expenses with operating income of subsidiaries
Internal Restructuring

Recent Trends

- Utilization of LLCs over corporations – Two primary methods:
  - (2) **Conversion by statutory merger into new LLC**
    - Some states do not have conversion statutes (e.g., PA, WA, MD)
    - A new LLC may be created or an existing LLC may be utilized
    - A legal merger of the corporation into the LLC must occur with the LLC surviving the transaction
    - Treated as a statutory merger for federal tax purposes (§ 368(a)(1)(A))
Conversion by statutory merger into a new LLC: if assets are being left behind, the transaction may not qualify as a § 332 liquidation. Achieve the same result by merging SUB B, Inc. with and into New SUB B, LLC under § 368(a)(1)(A)
Recent Trends

- Utilization of LLCs over corporations – Key tax considerations:
  - Solvency of affected entities
  - Stock basis from original acquisition
  - State implications of prior state deferred transactions
  - Credit facility implications
  - Risk tolerance
  - Disregard treatment is only an income tax fiction – LLC will generally have separate treatment for sales tax, property tax, etc.
Recent Trends

- Matching profitable and unprofitable subsidiaries
  - Overall loss companies with profitable subsidiaries
  - Overall profitable companies with stranded loss subsidiaries
  - Stranded NOLs
  - Multiple subsidiaries filing tax returns in duplicate states
  - Corporate headquarters functions not aligned with operating subsidiaries
  - Matching can be effectuated through use of LLC disregards
Internal Restructuring

Recent Trends

- Outside debt stranded at parent holding company
  - Allocate interest expenses to operating companies
    - Operating companies can take the conduit-exception to a state’s add back statute
    - Is this a dividend?
  - Dividend not to parent company
    - Solvency of subsidiaries
    - Sufficient earnings and profits ("E&P") to declare dividend
    - Potential debt restrictions
    - Capital gain if in excess of stock basis
Recent Trends

- **Outside debt stranded at parent holding company (cont’d)**
  - Negotiate with bank to make each subsidiary primarily liable for a specific amount
    - Potential refinancing costs
    - May not allocate 100% of outstanding debt
  - Establish intercompany agreements to create legal obligations
    - State add back statutes
  - Convert operating subsidiaries to LLCs
Internal Restructuring

Recent Trends

- **Management Fee Allocation**
  - Management fee incurred at parent company or separate subsidiary
    - Allocations made to subsidiaries on liability and state operations
    - Allocation methodology is often not formalized
    - Transfer pricing documentation does not exist or needs updating
  - Considerations
    - Documentation
      - Rational basis for management fee allocation
      - Intercompany agreement documenting allocation methodology
      - Valid transfer pricing study / intervals for transfer pricing updates
    - Nexus
    - Transfer Pricing
Internal Restructuring

Recent Trends

- **Nexus Management**
  - Manage activities in high-tax jurisdictions
    - Isolate key functions or activities (procurement; distribution; services)
    - Isolate back office or support center activities
    - Seek tax credit/incentives for new growth
Recent Trends

- Nexus Management (cont’d)
  - Considerations
    - Sales of TPP
    - Bright-line nexus standard
    - Agency nexus
    - Affiliate nexus
    - Nexus-creating activities (travel, etc.)
    - Contracts with customers, vendors, and government agencies
    - Transfer of affected employees
    - Intellectual property ownership changes
    - Transfer pricing of intercompany sales
    - Real estate property transfer
III. Implementation Process
Implementation Process

- **Project Evaluation Process**
  - Consider business needs, objectives, and/or limitations
  - Perform a review of each legal entity to understand any business concerns and/or tax issues
  - Consider the impact of outsourcing
  - Review the federal, state, and international income/franchise tax posture of the legal entities
  - Understand tax attributes of each entity
  - Consider state transaction tax costs – e.g., sales, real estate transfer, and gross receipts taxes
Implementation Process

- Project Evaluation Process (cont’d)
  - Develop simplification proposal that minimizes state transaction tax costs
  - Consider local business and regulatory considerations that may limit ability to eliminate certain entities
  - Model financial and tax impact of possible structures and scenarios
  - Always ensure that specific proposals are targeted to achieve stated goals
Implementation Process

1. Establish roles and responsibilities over the project
2. Approach, scope, and data collection strategy
3. Identify the key inventories and document collection/analysis methodologies
4. Review and understand business of each legal entity

- Understand any business limitations or considerations that may constrain restructuring plans
- Review and understand taxable income position, including attributes, of each entity
- Model income and franchise tax implications of the potential restructuring transactions
Implementation Process

1. Revise structure, as needed, based on income/franchise tax projections
2. Research and review transaction tax (sales/use and real property) consequences of revised structure
3. Revise structure, as needed, based on transaction tax impact
4. Review and confirm all issues are addressed
5. Finalize structure
6. Draft implementation steps
7. Prepare regulatory filings, corporate documents
Implementation Process

- Implementation in stages facilitates management of process and allocation of internal and external resources. For example:
  - Stage 1: Dormant and inactive entities
  - Stage 2: Non-regulated entities
  - Stage 3: Regulated entities and industries
  - Stage 4: Partnerships and passive investments

- Barriers to implementation at later stages do not preclude efficiencies achieved in earlier stages

- Present stages/timing to management

- Calculate tax benefit

- Create and implement a step plan for project
Implementation Process

- Rationalization requires full corporate, legal, and business support
  - Ensure coordination between the company’s internal teams and the company’s outside corporate, legal, and tax advisors
    - Involvement can be tailored to needs at each stage
    - Ensures consistency between evaluation, documentation, and execution
Implementation Process

- Due diligence on entities should consider the following factors:
  - Insurance and risk management impact
  - Litigation
  - Real estate and environmental
  - Regulatory and government approvals
  - Solvency
  - Tax attributes
  - Internal and external financing, including debt covenants
  - Third-party contracts
  - Human resources, payroll, and employee benefit plans
  - Accounting and treasury
  - Information systems
IV. Appendix

YOU LOOK SO MUCH THINNER!

THANKS! I HAD MY APPENDIX REMOVED...

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Appendix

Type A Reorganization

- § 368(a)(1)(A) – reorganization includes statutory merger
  - Assets and liabilities of transferor unit become assets and liabilities of acquiring entity
  - Target ceases separate legal existence
  - Continuity of Business Enterprise ("COBE") requirements
  - Indirect satisfaction of COBE – acquiring corporation treated as holding all assets of members of qualified group
  - Continuity of Interest ("COI") requirement
    - Substantial part of the value of proprietary interests in target is preserved
  - Business purpose requirement
  - Facilitates multiple drop-downs of property
  - Upstream merger followed by a transfer (or drop-down) of assets of the target - § 368(a)(2)(C) transaction
  - Compare upstream merger without any such transfer - §332 liquidation
  - Downstream merger – if pursuant to statutory law, a Type A Reorganization
Appendix

Type A Reorganization

- § 368(a)(2)(C) Principles
  - Type A Reorganization is not disqualified because part or all of the assets acquired are transferred to a controlled corporation
  - Rev. Rul. 69-617 – upstream merger followed by a downstream transfer of assets
  - § 332 not applicable – not a complete liquidation
  - Subsequent downstream transfer does not impact qualification of Type A Reorganization
  - Treas. Reg. § 1.368-2(k)(1) – transaction qualifying as a reorganization not recharacterized or disqualified as a result of subsequent or successive asset transfers
  - Any subsequent transfers will not cause valid reorganization to be recharacterized
Appendix

Type B Reorganization

- § 368(a)(1)(B) – reorganization includes an acquisition of a target’s stock in exchange **solely** for the acquiring corporation’s voting stock
  - “No boot in a B” – **no** other consideration (“boot”) is permitted
  - Voting stock can be the stock of a corporation in control of the acquiring corporation
  - Acquiring corporation should control at least 80% of the voting stock and 80% of each class of stock of the target corporation immediately after the reorganization
  - Acquiring corporation takes a carryover basis in the target’s stock
  - Target retains all of its assets with its original basis
  - Target shareholders receive shares in the acquiring corporation, or in a corporation in control of acquiring, and have the same basis in those shares as their original target shares
  - COBE requirement
  - Business purpose requirement
Appendix

Type C Reorganization

§ 368(a)(1)(C) – reorganization is the acquisition of substantially all the target’s property in exchange for voting stock of the acquiring corporation or its direct controlling parent corporation, followed by a distribution of the acquiring corporation stock to the target shareholders in a liquidation
- Substantially all consists of at least 70% of the target’s gross assets and 90% of the target’s net assets
- At least 80% of the consideration must be voting stock
- Acquiring corporation takes a carryover basis in target’s assets
- Target shareholders receive shares in acquiring corporation’s parent corporation and have the same basis in those shares as their original target shares
- COI requirement
- Business purpose requirement
Appendix

Type D Reorganization

- § 368(a)(1)(D) – reorganization includes transfer by one corporation (transferor) of all or part of its assets to another (transferee) and, immediately after the transfer, transferor (or its shareholders) are in control of the transferee
  - As part of the reorganization, stock of the transferee distributed in a transaction qualifying under §§ 354, 355, or 356
  - § 368(c) control – ownership of stock with at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation
  - Acquiring corporation takes a carryover basis in target’s assets
  - Target shareholders receive shares in acquiring corporation that have the same basis as their original target shares
  - COBE, COI, and business purpose also must be satisfied
  - Added hurdle if it is a divisive Type D Reorganization, implicating § 357(c)
  - Consider the impact of “cash D” regulations
Appendix

§ 332 Liquidation

- § 332(a) provides no gain or loss recognized by a corporation on receipt of property distributed in complete liquidation of another corporation

- § 332(b) requirements:
  - Parent must own stock of a subsidiary meeting the requirement of § 1504(a)(2) (80% or more of total vote and value) on date plan of liquidation is adopted and until liquidation is complete
  - Liquidating distributions must be in complete cancellation (redemption) of subsidiary stock
  - Liquidating distribution must be made either within a single tax year or completed within 3 years pursuant to plan of liquidation
  - Subsidiary must be solvent

- Under § 337(a), no gain or loss recognized by the liquidating corporation in a qualifying § 332 liquidation
Appendix

§ 351 Principles

- No gain or loss recognized in connection with the transfer of property to a corporation if, immediately after, transferor(s) are in control
  - “Control,” defined in § 368(c): ownership of stock with at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation
  - Services are not property for purposes of § 351
- With a transferee-corporation’s stock later transferred by transferor to a controlled corporation, control immediately after is not violated – Rev. Rul. 2003-51
- Property transferred to transferee in § 351 transaction may be dropped-down into lower tier entity – Rev. Rul. 77-449
- Multiple asset drop-downs and successive § 351 transactions permitted
Appendix

§ 381 Principles

- Generally, acquiring corporation succeeds to and takes into account tax attributes of distributing or transferring corporation.
- Under § 381(a)(1), distributee in a § 332 liquidation succeeds to tax attributes of the liquidating corporation.
- Under § 381(a)(2), the transfer of tax attributes applies to an acquiring corporation in a § 361 transaction, if in connection with a Type A, Type C, or Type D Reorganization.
- Date of the distribution of the transfer (that is, the date in which the distribution or transfer is completed) controls for purposes of determining the date upon which acquiring succeeds to target’s tax attributes.
- Attributes covered by succession rule of § 381(a) include NOL carryovers.
- Also covered – E&P of distributor or transferor generally deemed to be received by the acquiring as of close of the date of the distribution or transfer.
- If distributor’s E&P are already reflected in acquiring corporation’s E&P (per -33), the E&P to which acquiring succeeds to are adjusted to prevent duplication.
Eric Tresh
Sutherland Asbill & Brennan LLP
404.853.8579
Eric.Tresh@sutherland.com

Robb Chase
Sutherland Asbill & Brennan LLP
202.383.0194
Robb.Chase@sutherland.com
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