Kicking Off a Phased Approach

Following the global pandemic, there was a large volume of M&A activity that impacted a number of organizations and in turn, the prioritization of planning opportunities within tax departments. However, as the M&A environment experiences a decrease in activity, it gives companies a chance to turn focus on other planning opportunities. One common planning idea is Legal Entity Rationalization (LER), which at a high level streamlines an organization’s legal entity structure to achieve efficiencies and realize selling, general, and administrative (SG&A) cost savings, as well as potential tax savings. What type of organization is a strong candidate for this opportunity? While there could be multiple reasons for contemplating this initiative, one common fact pattern is an organization that has closed on one or more transactions in recent years, potentially resulting in a legal entity structure that is inorganic and inefficient. For organizations that fit this fact pattern, now may be the time to assess the legal entity structure and think about moving forward with a formal “clean-up” plan. But how would an organization go about starting what could be a potentially daunting planning initiative?

Typically, the primary hurdle for pursuing this initiative is gaining buy-in from stakeholders of the organization, or in other words, the company’s functional decision makers. Depending on the size of a company’s legal entity structure, as well as the number and type of jurisdictions involved, a large-scale LER project could last multiple years and more importantly be a costly investment. To avoid deterring stakeholders from pursuing this type of project, a common approach that can help kick start these initiatives is considering a “Phased Approach” with an initial focus on assessing and potentially eliminating dormant entities. This allows the LER project to get started with a small investment that can reduce administrative costs associated with keeping inactive entities in existence. Once these cost savings are realized, there’s often a bigger appetite to focus on rationalizing active entities within the organization, which often yield even larger savings down the road.

Starting a Dormant Entity Elimination Phase

The real fun begins when the LER concept becomes reality, and the first phase begins. Dormant entities are ones that once had a purpose, no longer conduct business, but are still part of the overall organizational structure because of the perception that it takes a considerable amount of time, energy, and costs to dissolve the entities. When companies retain dormant entities that stay stagnant, it results in unnecessary fees and administrative work that require annual upkeep (from a personal perspective, think of that monthly gym membership or tv subscription that goes unused for years but is never cancelled). Some of these common expenses associated with dormant entities are direct and indirect tax filings (nil filings), business licenses, personal property tax filings, franchise tax filings, insurance policies, minimum deposit costs for bank accounts, registered agent costs, etc., all of which add up over time. Once the dormant entities are identified it is usually not a complex exercise to dissolve or liquidate entities given there is limited to no balance sheet clean up, employees, or operational activity to address. This means that there may not be a need to adhere to strict timing considerations, such as year-end elimination for a clean break in payroll reporting, and the entities can be eliminated in conjunction with the organization’s timing preference. Of course, the organization will need to vet activity and balance sheet data to determine there are no surprises to address, but overall should be less complex than eliminating an operating entity.

Although Easier, It Still Requires an Organized Approach

Even when starting with a Phase I such as rationalization of dormant entities, there is still a reason to follow a process. No matter the difficulty level of the project phase it is important to develop an execution plan, as the simplest of projects can fail without one. Certain components in developing an execution plan include identifying key stakeholders and task owners, mapping out a timeline with tiers of priorities, and
understanding potential risks and issues. Identifying key stakeholders ensures that the plan is carefully vetted and provides a governance structure for accountability. Identifying task owners assigns clear roles and responsibilities for the specific day to day tasks of the LER. Mapping out a timeline with tiers of priorities will help provide a structure and methodology for executing the LER within the key stakeholder’s desired timeframe. Understanding potential risks and issues allows the team to be proactive to mitigate roadblocks that could cause delays or failures for any part of the rationalization and helps facilitate the coordination of solutions across the organization’s functions. It is not solely about getting to the finish line, but about how to get there. The **how** is key because it focuses on putting a process in place that can be leveraged once the LER moves on to more difficult phases.

Consider Company X, a multi-jurisdictional organization, that has executed three acquisitions within the last five years. As a result, Company X now has almost 300 entities of which 40 percent are dormant and 60 percent are active. Company X decides to initiate an LER project and begins with a Phase I to address the dormant entities. Based on a prior benchmarking exercise, an elimination of a dormant entity could equate to annual cost savings of at least $5-10k USD, or maybe even higher given the company’s specifics. This could result in not only cost savings, but also free up personnel hours to focus on more value driving activities within the organization. Additionally, if a company decides to execute Phase II and beyond to address the entities with redundant business operations or duplicative jurisdictions, the cost savings amount would likely increase, resulting in substantial savings and benefits over time.

**What can you do today?**
If you think LER is applicable to your company but the investment is too large for the entire organizational structure, dormant entities are a great starting point as a Phase I, since the entities are inactive and there is limited disruption to the business. As you gain experience and understand the ins and outs of rationalizing, you can think through the nuances to consider moving forward to address the more complex entities in your structure. Though carving out time and resources may be an upfront cost, the long-term benefits can far outweigh any immediate pain points. Rationalizing entities, eliminating redundancies, and refining the overall organizational structure will launch future operational efforts, business strategies, and potentially reveal other cost saving opportunities that can setup the business to function efficiently and will motivate you to see what else is possible.

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