Legal entity readiness

Are you balancing Day 1 preparation with long-term tax efficiency?

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Acquisitions of divisions and lines of business have heated up as companies and investors seek competitive advantage in an uncertain economy. Whether you are a strategic buyer seeking to increase geographic footprint or a private equity investor, an important success factor is likely to be the execution of a tax efficient legal entity structure to acquire businesses.

Too often, buyers piece together legal entity needs in a hurry — and in a vacuum — creating a structure that is cumbersome and costly to maintain. But having the right legal entity structure on "Day 1" can provide opportunities to increase company and deal value. This article examines some common challenges, risks, and misconceptions related to establishing a legal entity structure, as well as suggestions for developing a detailed plan that navigates the multitude of interdependencies to address short- and long-term transaction goals.

The CFO wants to close in November, but we don't have presence in 11 jurisdictions. While many executives and advisers value speed to close, this often conflicts with strategic acquisition/integration planning and development of an appropriate and efficient legal entity structure. In fact, you will need to establish many of the factors essential to deal success during the critical preclose period, including the ability to sell products or perform services legally, hire and pay employees, take orders and invoice customers, pay vendors, purchase materials, import and export goods, and, most importantly, collect cash. On top of that, you must address the complexities related to managing cash taxes, cash withholdings, capital deployment, and new tax laws and regulations, all while managing corporate structure overhead costs. And, your legal team must draft transaction documents while your treasury team moves cash and debt associated with the deal — steps that require correct legal entity names, licenses, and registrations that may take weeks, if not months, to acquire. With this amount of complexity, and pressures, to move quickly, it is almost a foregone conclusion that many transactions result in inefficient structures that fail to capture potential tax benefits or achieve synergy targets.

Measure twice, cut once . . . the risks of not having a plan. Hastily created legal entity structures also may jeopardize longer-term operational performance. While legal entities may meet minimum registration and trading requirements, their structure may create operational inefficiencies and prevent you from realizing the synergies that drove the transaction in the first place. For example, you may want to integrate the merging entities' accounts receivables functions, but if the legal entity structure dictates two separate trading entities, then you may end up with inefficient processing and handling of accounts receivable for common customers.

Your legal entity structure also will have a strong influence on the finance, accounting, information technology (IT), and supply chain functions. These functions must make operational decisions based on legal entity structure; decisions that can be difficult and costly to unwind later on. For example, your legal entity structure influences the number of company codes incorporated in your enterprise resource planning (ERP) system. Changing your legal entity structure could delay IT integration efforts or worse — it could change customer interface processes, disrupting customers who already have had to adjust to new processes.

Issue free on Day 1; tax efficient in the longer term
Tax legal entity planning can create not only an issue-free Day 1 but also an efficient structure for the longer term — one that has embedded technology solutions that allow seamless compliance with reporting requirements and efficient transfer pricing policies. Planning should involve investigation of available credits and incentives and the mitigation of potential tax and successor liabilities. Key planning benefits include enhanced risk management and cash savings in operating the structure.

We just set up a new LLC in Illinois; it was two forms, a credit card number, no problem. Many acquirers underestimate the complexity of establishing a multijurisdictional legal entity structure. In short, each entity — corporation, flow-through LLC, registered branch, or other form — must have the legal ability to operate the business. And, operationalizing a legal entity requires securing bank accounts and business and tax identification numbers, as well as establishing the technology necessary to facilitate compliance and financial reporting requirements. The real challenge here is that each country and each U.S. state and local jurisdiction requires different documents, financial statement representation, management representation, notaries, and numerous other items in order to formalize the entity and register to do business. Many countries allow nominee directors to begin the process, and service providers also can assist, but formation ultimately requires local country presence or nonresident directors with additional requirements. Proper planning is critical to avoid trapped capital, unintended taxation, and additional local administrative requirements.

The potentially costly consequences of missing a global trade requirement

A missed dependency related to operations or trade compliance can close a border to the company, and reapplication or revisions to import/export and local certification/licensing requirements can cause significant delays. For example, equipment used by consulting firms in telecom applications requires a license for proper entry into a country and for removal for repairs. Another common example is customs or business license bonds.

The BRIC countries — Brazil, Russia, India, and China — present particular challenges. Readying a business entity to accept assets and operate in these leading developing countries can be cumbersome, to say the least. In Brazil, for example, regulatory and tax registration documents must be submitted in Portuguese, and the U.S. GAAP financial presentation does not align with the local taxation and import/export authorities' forms. China, which allowed rather liberal application of representative office regulations, recently enacted and enforces a more formal legal entity approach for foreign company operations. Fortunately, the BRIC countries generally offer some flexibility that allows U.S. tax efficiency, with flow-through legal entities available and gaining widespread use. Still, setting up operations via a legal entity or registered branch in any non World Trade Organization country can take six months or more — and that is without encountering complications.

Clear, well-conceived plans contribute to a smooth Day 1. Two key planning documents — a Day 1 blueprint and a legal entity readiness plan — can potentially speed up and smooth the path toward establishing an efficient legal entity structure.

A Day 1 blueprint does several important things to facilitate planning. It compares current tax processes for each company and/or lays out the desired end-state processes between and across entities. It identifies cross-functional interdependencies and systems dependencies, as well as providing a holistic view of dependent issues, such as the desired and/or required residence of intellectual property, revision of or new transfer pricing agreements, and ability of ERP systems and accounting to provide necessary legal entity tax financial data for a smooth monthly, quarterly, and year-end close. It also facilitates the development of the future-state legal entity structure as well as the key Day 1 requirements for each legal entity.

Preparing a blueprint early can have financial benefits, providing the insight necessary to reduce the cost of business operations (often significantly), reduce potential tax penalties or fines, pursue future tax benefits, and/or close the books in a timely manner. It also creates a view of the supply chain and desired billing and collections processes, which in turn can help identify potential tax synergies during legal entity structure setup — something that will be even more critical in the evolving tax environment. Finally, development of the blueprint in close coordination with the deal team can manage the risks associated with funding and capitalizing new or combined entities.

The legal entity readiness workplan defines the activities required to achieve entity Day 1 requirements and reach your desired legal entity future state. It should consider impacts on your employees and customers and set out clear communication processes to reduce confusion. If employees are to transfer to new entities, then the workplan should address local requirements such as works council approval and changing benefit plans prior to the transaction in order to avoid penalties and/or delays in closing. The workplan also should address change-in-control provisions in employment contracts, as well as vendor and customer contracts to be acquired or otherwise transferred. And, if you are entering a jurisdiction for the first time, the workplan should provide for comparing the costs of establishing new local contracts with the costs of globally negotiated services contracts.

Most importantly, preparing a Day 1 blueprint and a legal entity readiness plan early will help create a consistent approach between functions, enabling you to identify critical interdependencies, make informed decisions, and coordinate activities to reduce future costs and capture synergies throughout the legal entity structure.

The deal closes September 30, but… Every transaction presents deadlines that challenge Day 1. Workaround planning for cross-border transactions that involve countries with long lead times may require phased closes or transition agreements — which, in turn, have tax implications. One strategy that, in some cases, may allow the NewCo to contract locally and then subcontract with the seller to execute until a local country close is possible is a transitional registration. In distressed company acquisitions, third-party providers often service a local jurisdiction under license or other agreement.

A detailed plan that aligns with all dependencies and transaction goals can lead to Day 1 success.
Assuming that Day 1 readiness is as simple as a filling forms and obtaining a registration number usually results in costly, time-consuming headaches. In fact, there are a host of interdependencies involved in developing a legal entity, and these can be wide ranging — extending from transaction readiness issues, such as registrations, licenses, and bank accounts, to operational issues, such as transfer pricing modeling in the ERP system, import/export requirements, sales taxes, payroll taxes, value-added taxes/indirect taxes, and systems. For example, to set up payables and payroll in the ERP system, you need a bank account. To set up the bank account, you need a tax identification number. To obtain a tax identification number, you need to provide a certified translation of the articles of incorporation — and so on.

You will need a detailed plan — developed early on and ideally by a cross-functional team — that identifies and tracks these critical dependencies across entities and facilitates development of a legal entity structure.

Legal entity readiness planning ultimately produces a structure that maintains tax efficiency while establishing the business operations and governance necessary to do business on Day 1. With careful planning and a holistic view, it is possible to achieve not only an issue-free Day 1 but an efficient, effective structure thereafter.