

Legal entity restructuring and reorganisations – why now?

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It was the best of times, it was the worst of times,” so starts Dickens’ timeless masterpiece, *A Tale of Two Cities*. For many C-Class executives, the current recession has certainly been the worst of times, at least in their business careers. However, as companies take a hard look at their current operating structures, both legally and functionally, it is the best of times to achieve not only operational efficiencies but also tax efficiencies. This article discusses and illustrates, through a case study, some of the tax benefits that can be achieved through restructurings for a corporation conducting business in more than one tax jurisdiction.

Key tax drivers

In addition to operational drivers for a company to undertake an internal reorganisation during a downturn economy, some of the key tax drivers include: (i) reduce administration cost, as well as tax and legal risk by reducing the number of legal entities; (ii) consolidate operations by geography or other criteria thereby enhancing use of tax attributes; (iii) facilitate either internal or external financing needs with tax optimisation; (iv) maximise after-tax benefits derived from intangible property and R&D functions; and (v) achieve local country tax savings and/or maximise US tax deferral opportunities.

Other key drivers that will facilitate the internal reorganisation of companies with operations in Europe, are the European entity, Societas Europaea, and various EU Merger Directives which have now been implemented in the local statutory framework of many European countries. Although a specific tax regime existed for cross-border mergers within the EU since the 1990s, no corresponding legal framework had been developed within key Member States until recently. (EU Directive 2005/56/CE, dated 26 October, 2005, on cross-border mergers of limited liability companies, has been implemented, inter alia, by France, Italy, Spain, the UK, and the Netherlands.)

In principle, without special rules, whether transacted within one jurisdiction or between jurisdictions, a merger of two different companies

would be treated as a discontinuance of a business in one legal entity and the transfer of assets used in that business to a new entity. This would generally result in: (i) an immediate taxation of profits; (ii) taxation of unrealised gains on assets; and (iii) the recapture and taxation of provisions. However, ‘tax neutrality’ and ‘tax-deferral’ rules related to mergers (which now include mergers of companies in two different European Union jurisdictions) allow for: (i) a tax exemption on capital gains at the moment of the merger (the non-taxed gains on the transfer of assets will either be added back into income over a certain time period, or taxed at the moment of the assets’ later sale by the surviving company); (ii) a transfer of provisions booked by the merged company, provided that their purpose remains relevant at the level of the surviving company; and (iii) the possible transfer of deficits (net operating losses) and other tax attributes existing at the level of the merged company. Accordingly, given the fact that many key European Union Member States now have both the tax and legal frameworks for executing cross-border mergers and reorganisations on a tax deferred or tax neutral basis and given President Obama’s proposals to drastically reform US international tax laws, now is certainly the time to undertake such restructurings.

Given the more favourable atmosphere within Europe for reorganisations, we have provided below a brief case study which highlights some of the benefits of implementing a corporate restructuring.

Case study – the facts and objectives

Case study facts. A US multinational corporation (USP), recently acquired a UK multinational corporation (UKP), and made a section 338 election with respect to UKP and its subsidiaries. (A section 338 election made by a US acquiring company of a non-US target company essentially allows the step-up, for US federal income tax purposes, of target’s assets without any tax consequences to the acquiring company.) Prior to the acquisition, USP carried out Businesses A & C, and held various European subsidiaries through a Dutch holding company (Dutch-L). The European subsidiaries (the legacy subsidiaries), are: Italy-L, which is in the A Business, and is currently generating losses; France-L; and Spain-L, which carries out Businesses A (which has losses) and C (which is profitable).

The UKP Group, which carries out Businesses A & B, is comprised of the following: France-N which is a distribution company and has real estate assets; Spain-N, which has profits both from the A and B Businesses. Italy-N, which has real estate which is not strategic to its manufacturing activities, forecasts high EBIT and high taxable income for years 0 to 3.

Objectives. Given the recent economic downturn, USP’s management team has set forth the following objectives (among others) to achieve through an internal reorganisation: (i) combine French and Spanish distribution subsidiaries to eliminate overlap related to Business A, and leverage expertise in other business lines; (ii) reduce overhead costs; and (iii) combine operations to allow for income tax consolidation (i.e., offset losses and credits among entities).

With tax neutral cross-border merger possibilities in Europe being enhanced by the implementation of the EU Merger Directives, now is the ‘best of times’ to analyse internal restructurings to enhance a company’s financial position.

Case study – steps / transactions and tax benefits

To achieve the above stated reorganisation objectives, the following restructuring steps should be considered.

Spain. Unlike the UK, Spain requires direct or indirect holdings in order to offset losses or transfer assets intragroup tax free. Accordingly, in order for the USP group to obtain benefit for Spain-L's losses related to the A Business as soon as possible, a merger should be implemented between Spain-L and Spain-N. This could be effected on a tax free (tax neutral) basis in Spain, assuming certain requirements are met. The resulting structure would be slightly more complicated from a legal standpoint, i.e., Spain-L, which would be the surviving entity, would be owned by UKP and Dutch-L.

France. Management should consider effecting a cross-border merger by combining the A Businesses of the French and Spanish subsidiaries. This would require a multi-step restructuring: (i) Spain would restructure its operations into three distinct subsidiaries, with each subsidiary carrying on a distinct business, with all three businesses held by a Spanish Holdco (the A Business would be held by Spain-NewcoA; (ii) France-N contributes the French A Business to a French Newco; (iii) French Newco is contributed to Spanish Holdco; (iv) French Newco is merged with, and into Spain-NewcoA, and becomes its French branch. This merger will reduce administrative costs associated with multiple legal entities, streamlines Business A activities by combining them cross-border between France and Spain thereby reducing total overhead costs, and facilitates cash flow between France and Spain.

Italy. Various restructuring alternatives should be explored by USP vis-à-vis its Italian operations. One possibility relates to creating an intercompany loan between Italy-N and Dutch-L. This would be achieved by

UKP first acquiring 25 percent of Dutch-L, followed by Italy-N acquiring 100 percent of Italy-L's shares by means of an intercompany loan from Dutch-L to Italy-N. The gain on sale of Italy-L realised in Italy by Dutch is not subject to tax in Italy pursuant the Dutch/Italy Treaty and the interest paid by Italy-N to Dutch-L is deductible for Italian income tax purposes (and exempt from withholding tax). The capital gain is not taxable at the Dutch level due to the participation exemption. The interest is taxed at the Dutch level (possibly at a 5 percent rate starting in 2010). After Italy-L is acquired by Italy-N, it merges with and into Italy-N on a tax free / tax neutral basis. Italy-N's profits (including the gain on the sale of the real estate) are set off against Italy-L's losses. These restructuring steps allow for the combination of activities to reduce overhead costs, the use of losses from one company against profits of another, and a reduced overall foreign tax rate through tax efficient financing.

The above restructuring possibilities are just a few of the benefits that can be achieved by multinationals looking to streamline their corporate structures in today's tighter economic times. With tax neutral cross-border merger possibilities in Europe being enhanced by the implementation of the EU Merger Directives, and given President Obama's proposals to significantly reform US international tax laws, now is the 'best of times' to analyse internal restructurings to enhance a company's financial position. ■

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