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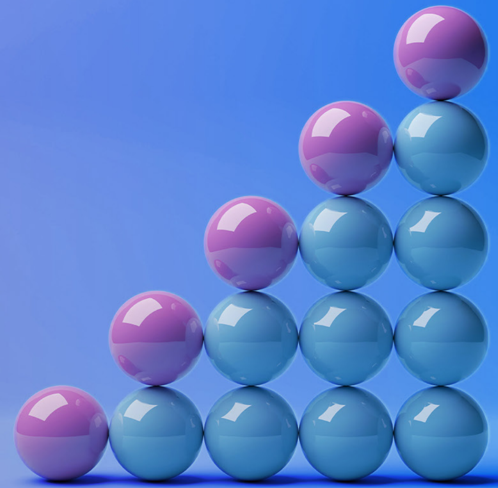

## Legal entity rationalization

**Elizabeth L'Hommedieu (00:00):**

Hi everyone. Welcome to today's podcast. I'm Elizabeth L'Hommedieu, a principal in KPMG's Banking & Capital Markets Tax practice. And today I'm joined by colleagues to talk about legal entity rationalization or LER and what we're seeing around this in the banking industry. So please welcome Tony Welburn from our Banking & Capital Markets Tax practice and Mitchell Thweatt and Megan Fitzsimmons from KPMG's M&A Tax practice. Thank you for joining me. So, let's start with the basics. What is LER? Megan, can you talk us through that?

**Megan Fitzsimmons (00:35):**

LER is the process by which companies look at their organizational structure and look for ways to save money or create value. Essentially, you look at your organizational structure, look at the entities that you have, and say, "okay, what purpose does each of these entities serve?" And if you have some entities within your structure that no longer serve the purpose that they originally had, maybe you acquired some dormant entities through acquisitions or maybe you have some redundant entities if they no longer serve the purpose. How much money could you save if you eliminated those entities? So, you calculate or estimate how much money you're spending, say on tax compliance or on legal compliance to keep around entities that no longer serve the purpose that they once had. And then you start to gather some information about how to go about eliminating those entities. And you can compare what would it cost to eliminate the entities, and what is it costing to maintain those entities? And you can compare the savings to the cost of maintenance and figure out what is worthwhile to eliminate. And then the other information that you gather for the elimination process is presumably some federal and state tax attributes. For example, you've got a dormant entity, but that happens to have a valuable net operating loss, a tax loss inside that entity that you want to preserve. So, you want to eliminate that entity in a way that preserves the loss that you might someday be able to use. The same thing could be said about tax basis. Oftentimes entities that are acquired are a holding company and a target structure that might not have any purpose to you anymore after you've finished that acquisition. But that's where you happen to have the stock basis. So, if you have high outside stock basis, for example, you don't want to eliminate that entity even though it's dormant by liquidating it because then you'll eliminate that high outside stock basis. So rather than liquidate that entity, you want to think about maybe merging it sideways or some other reorganization strategy to preserve the stock basis. And then from there you've got a lot of data on all of your entities. So you look at all the entities in your structure, what purpose do they serve? Can I save some money by eliminating them and then how do I eliminate them? That's the first line process of legal entity rationalization. But through that process you gather a lot of information, right? Operationally, strategically tax attributes from a state and local and international perspective, you have a lot of information now about those entities. And so it can be a starting place for other considerations.

**Elizabeth L'Hommedieu (03:26):**

Thanks, Megan. That's a great description. And as I think about the banking industry, it seems like entity rationalization could be particularly relevant, right? Historically, this industry's had significant consolidation, mergers, acquisitions, and I think that often has left some really bulky org charts and duplicative special purpose entities. Tony, do you want to talk to us about what are you seeing in banking right now?

**Tony Welburn (03:55):**

When you think about our industry in banking, it's a great time to look at this not only from the cost savings in the tax space, but also the regulatory and accounting groups as well. All of our banking clients are going through significant

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pressures right now to reduce their efficiency ratios and cut costs. So, from that perspective of cost cutting, it seems for most of our industry it is top of mind. There's a real great business need to get at this issue. To your point, Liz, there have been a lot of acquisitions, particularly if we look at maybe not the last year or so with the regulatory environment, but certainly leading up to that significant consolidation, lots of large merger of equals. And as you noted, when we have that type of consolidation and bringing together two large financial groups, there often are REITs (real estate investment trusts) in both structures, perhaps a muni sub (municipal security subsidiary), some sort of securities entity, broker-dealers, leasing subsidiaries. In some cases, folks still have separate mortgage companies. And when you start to look at your org chart, you see oftentimes a lot of duplication and lots of times the line of business will tell you there's some reason that we really need to retain these entities. As we look across that in our clients, we're seeing a lot of large org charts inflated, if you will, with a lot of duplication.

**Elizabeth L'Hommedieu (05:38):**

Yes, I agree. And I think that particularly with some of those special-purpose entities, finance and accounting may not be as fond of them as perhaps a tax department. And so there's often times other parts of the organization that would be happy to reduce the amount of entities.

**Tony Welburn (05:54):**

Yes. And frequently we find that the tax department might have some ongoing responsibility in maintaining the books and records and perhaps in some cases even journal entries. So, the tax departments have compliance burden and sometimes other recordkeeping requirements and, certainly to your point, finance and accounting are often anxious to get those off their books. Another current industry issue is the case of having uninsured deposits outside of the bank. And it's a very hot topic right now with the regulators on how to treat intercompany deposits. There is also a need to eliminate cash outside of the bank to eliminate some of the uninsured deposit premiums that are being assessed against those accounts, so another reason to kind of get rid of some of those entities on your org chart.

**Elizabeth L'Hommedieu (06:49):**

That makes sense. And just to clarify, you're talking about if a bank subsidiary, for example, has cash on deposit with the bank. While oftentimes the bank views that as having the cash for liquidity purposes that can show up as an uninsured deposit for other regulatory purposes, right?

**Tony Welburn (07:06):**

Yes, that's right. And that is something that I understand the FDIC is looking at right now, and so that's exactly the issue.

**Elizabeth L'Hommedieu (07:15):**

If I think about the deal market, Mitchell, it does feel like in this industry and maybe across other industries as well, that we've seen a pause in a lot of M&A activity over the past several months, but that doesn't necessarily mean that it's not a good time for LER, is that right?

**Tony Welburn (07:34):**

No, that's right, Liz. And I think we have seen a pause in the deal markets, I would say in the last year or so, across this industry and more broadly across just the M&A space in general. I think it's the right time to be thinking about LER as people sort of have a little bit of downtime because they're not looking at deals. They can think about their corporate structure and whether it's an opportunity to take some time to clean it up so that when they do the next deal, they're not just adding to an already bulky structure. So, it's the right time to be thinking about LER and other planning opportunities.

**Elizabeth L'Hommedieu (08:03):**

That makes sense to do it when you're not in the heat of another deal. And like you said, to really get the org chart in shape so that you can absorb another merger down the road. You guys have all mentioned some form of cost takeout. Megan, is anything you can add around cost takeout? I think I agree with what Tony said 100 percent. Banks are always looking for this – are there certain things they should be looking at in particular with entity rationalization?

**Megan Fitzsimmons (08:31):**

I think the cost takeout point is a great place to start. That's sort of the lowest-hanging fruit. I think, then, once you've got the information that you've gathered about your org chart, there are tax planning strategies that you can look at. The process can morph, right? From rationalizing your structure, which people tend to think of as eliminating costs and costs relating to compliance or the regulatory burden that you and Tony were talking about, you can morph into planning strategies, right? For example, you're in this pause that Mitchell was describing, so you might be preparing for disposition, right? If the market comes back, you want things to be lean and clean, but maybe you also can think about state planning ideas like a payroll company. There are ideas that you can implement, planning ideas that once you've gather that information, and now that you have the time given this market pause, that you can start implementing, that can be a cross-border strategy or cross-border compliance or Pillar Two. There are a lot of new rules coming out all the time in that space that, once you have the information about your org chart, you can think through the best way to comply with those new rules. The best way to capture some value from some state tax planning ideas. I think it's a good time, and then you have the right information to start implementing some of those.

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**Elizabeth L'Hommedieu (09:52):**

Yeah, we talked about maybe entities aren't fit for purpose for what they historically were created for, but you raise a great point about making sure the entities are fit for purpose going forward because we do have a lot of tax regime changes looking ahead, right? We have Pillar Two and other things coming in and we need to make sure that the structures are ready for the future, not just the present. Now that we've switched this to tax, which is exactly where I wanted to go by the way, I want to talk about planning within the entity rationalization. So Mitchell, I'm sure that like anything else, there's tax-efficient ways and tax-very-inefficient ways to streamline a legal entity structure. So can you talk to us about some of the planning or tax benefits you see with entity rationalization?

**Mitchell Thweatt (10:42):**

As we think about, and I mentioned this earlier on, is that if you liquidate a subsidiary and that subsidiary is solvent, for example, that's going to be a tax-free liquidation and any basis that is inherent in the stock of that subsidiary is going to go away. So the question is, can we use that basis in a way that's useful from a tax planning perspective? Tony mentioned, you know, the way that uninsured deposits get accounted for now and, and the additional focus that regulators are placing on that. If we have a subsidiary, say for example you have two REIT entities that have a significant amount of cash, and neither of those entities, or only one of those entities doesn't have a built in loss or built in gain and in stock. Can we structure a reorganization in a way to bring that cash out tax free from a federal and state income tax perspective?

**Mitchell Thweatt (11:25):**

For example, by structuring it as a D reorganization, that's an opportunity to sort of get some cash back up to the bank potentially without triggering unintended tax consequences. If we think about loss planning as another strategy , we could think about worthless stock deductions. If you have an entity that has become wholly worthless because it's insolvent, can we liquidate that entity in a way that is a taxable liquidation that triggers the loss that's inherent in it shares. That loss can sometimes be ordinary. So that can be a benefit if you have a company that doesn't throw off a lot of capital gains, right? So they can have an ordinary loss. That's certainly planning that we see. The other part of it though is using, for companies like banks that can generate a lot of capital gain in their structure, just sort of inherently in their business is structuring a taxable liquidation.

**Mitchell Thweatt (12:14):**

There was a court case referred to as Granite Trust where the court blessed a taxable liquidation planning strategy. So we're still seeing a lot of that in the market today. And essentially there, what you do is you transfer the shares of an entity that may have a built in loss to an entity that's not included in the consolidated group like a REIT or a partnership and, and then you liquidate that entity. You would transfer basically 25% of the shares of the built-in loss entity outside of the group in a way that triggers a capital loss for tax purposes. So, these are just ideas of things that you can think about when you're thinking about LER and planning opportunities that may exist. There are certainly traps with the unwary and things that you'd have to think about like the Section 1502-36 rules, the unified loss rules and how that might impact the recognition of a built-in loss. We want to make sure that any reorganization transaction qualifies as a reorg. You want to make sure that any Granite Trust transaction doesn't qualify as a reorg. So definitely a lot of planning opportunities that may be available depending on the specific facts of your structure.

**Tony Welburn (13:15):**

From a market perspective for banks, I think this is a great time and several of the banks are looking at the fact that the current interest rate environment, is triggering a lot of built-in losses related to those loans that are on the books already in this rising interest rate environment. Those built-in losses in the loans, if they're held in a REIT for example, likely then are creating built-in losses in the stock of the REIT holding company structure. And that's often where we can find a benefit from a Granite Trust type of taxable liquidation.

**Mitchell Thweatt (13:56):**

That's right Tony. And we have seen questions just from a "is it still a viable option?" perspective. I think we saw the Biden administration proposed some legislation a couple of years ago that could have taken the benefit of the Granite Trust planning off the table. That legislation never passed. The IRS is actively looking at these in the market. The Bausch Health case is a case that's gotten a lot of press lately around Granite Trust transactions. I believe we a firm still get comfortable that it's a viable planning opportunity. It's just something that needs to be reviewed and validated as part of your exact facts that exist within your structure.

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**Elizabeth L'Hommedieu (14:27):**

Thanks guys. Those are great examples and I appreciate the update. Mitchell, I do think we saw a lot of these taxable liquidations Granite Trust type transactions some years ago. It's nice to know that they're still viable even though we're hearing some of it in the media currently. So, any practical advice, what would you tell a bank to be thinking about right now if they want to consider legal entity?

**Mitchell Treat (14:51):**

I think one thing is to think about where they have basis, right? Where does the tax basis in the stock of their subsidiaries exist? Where might they be able to get some benefits, or basis that they want to preserve for future planning? So those are things to think about when I think about some practical advice for banks these days.

**Tony Welburn (15:06):**

And then on the other side of it, I think where might you have losses looking at your portfolios and maybe getting a market value valuation or refresh to understand if you might have some built-in losses, economic losses that you might be able to realize.

**Megan Fitzsimmons (15:22):**

Often where we even start when we're trying to help clients understand if it's the right process for them: Think through the acquisitions and dispositions that you've done over the last few years. Have you added a significant number of entities to your structure? Do you have a handle on what each of those entities is doing or are you preparing to get rid of an entity or a business line? And you know, how positioned are you to, to make that disposition from within your group? I think just taking a look at your structure and figuring out how it's grown or shrunk, or how you're planning to make that grow or shrink, can also help inform the decision about whether this is the right time for you to look at this.

**Elizabeth L'Hommedieu (16:00):**

I think all of those points are excellent summaries and good advice for our banks considering this. And I think this has a lot of relevance in the banking industry right now. So thank you, Megan, Tony, and Mitchell. I really appreciate you talking us through this today, sharing your insights around entity rationalization and it was a great discussion. And to our audience, thank you for joining us today. This is Elizabeth L'Hommedieu on behalf of the KPMG Banking & Capital Markets tax practice. I look forward to talking again soon.

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