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Best Practices in Subsidiary Management

INTRODUCTION

What Are Subsidiary Management Operations

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Corporate entity information is business-critical data that makes its way into nearly every business process. The modern corporate legal department is often tasked with maintaining and operationalizing this data across the business for a number of different strategic purposes.

However, a recent survey by EY revealed that **89% of legal department leaders** reported substantial challenges with legal entity management giving them concerns about their deal readiness. Most seasoned legal professionals have seen transactions delayed because subsidiaries are not in good standing, have outdated appointee records, or other administrative friction.

This guide provides an overview of best practices to stand-up an effective subsidiary management operations function in your company.

CHAPTER LIST

What is Included:

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CHAPTER 1

Why is Subsidiary Management so hard to operationalize?

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There are typically three reasons why the management of legal entities is difficult to organize into a smooth function:

1 Entity management is often a "shared responsibility".

Legal entity management tends to be a "shared responsibility" between legal, tax and finance departments. **76%** of legal departments surveyed reported having five or fewer employees focused on entity management. However, **73%** reported leveraging finance departments and **53%** reported utilizing the tax departments in the entity management process. Cross-departmental collaboration is usually a substantial challenge for most large organizations that leads to friction around ownership and responsibility.

2 Outdated legacy legal entity management software.

96% of legal departments report issues with their legal entity management software. **72%** find it difficult to keep systems updated and **62%** found it challenging to track governance activity statuses.

3 No centralized management of local service providers.

As companies grow, they tend to naturally leverage a decentralized mesh of law firms by managing entities for basic statutory compliance. This model can create coordination and cost management challenges. Currently, **47%** of legal departments currently operate in this decentralized model.

Failure to effectively manage subsidiary entities can lead to a variety of consequences. A relatively low impact cost is simply the administrative and regulatory friction of having to retroactively fix problems that occurred from poor management (e.x., filing previous years annual reports to bring entities into good standing.) However, there are more serious consequences that can manifest if subsidiary management is not properly operationalized, such as:

- Delaying strategic transactions such as IPOs, financings, or M&A.
- Dissolved entities that leave assets stranded with no direct ownership link to the parent
- Directors appointed to subsidiary boards that are no longer employed with the company so board resolutions cannot be effectively signed

An even more problematic consequence is piercing of corporate veils by courts to hold parents liable for subsidiary actions in litigation. Proper subsidiary management should constantly be generating evidence that the subsidiary has a distinct mind and interest from the parent, thus creating an evidentiary basis of unique corporate identity.

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CHAPTER 2

Alignment on Subsidiary Governance Framework

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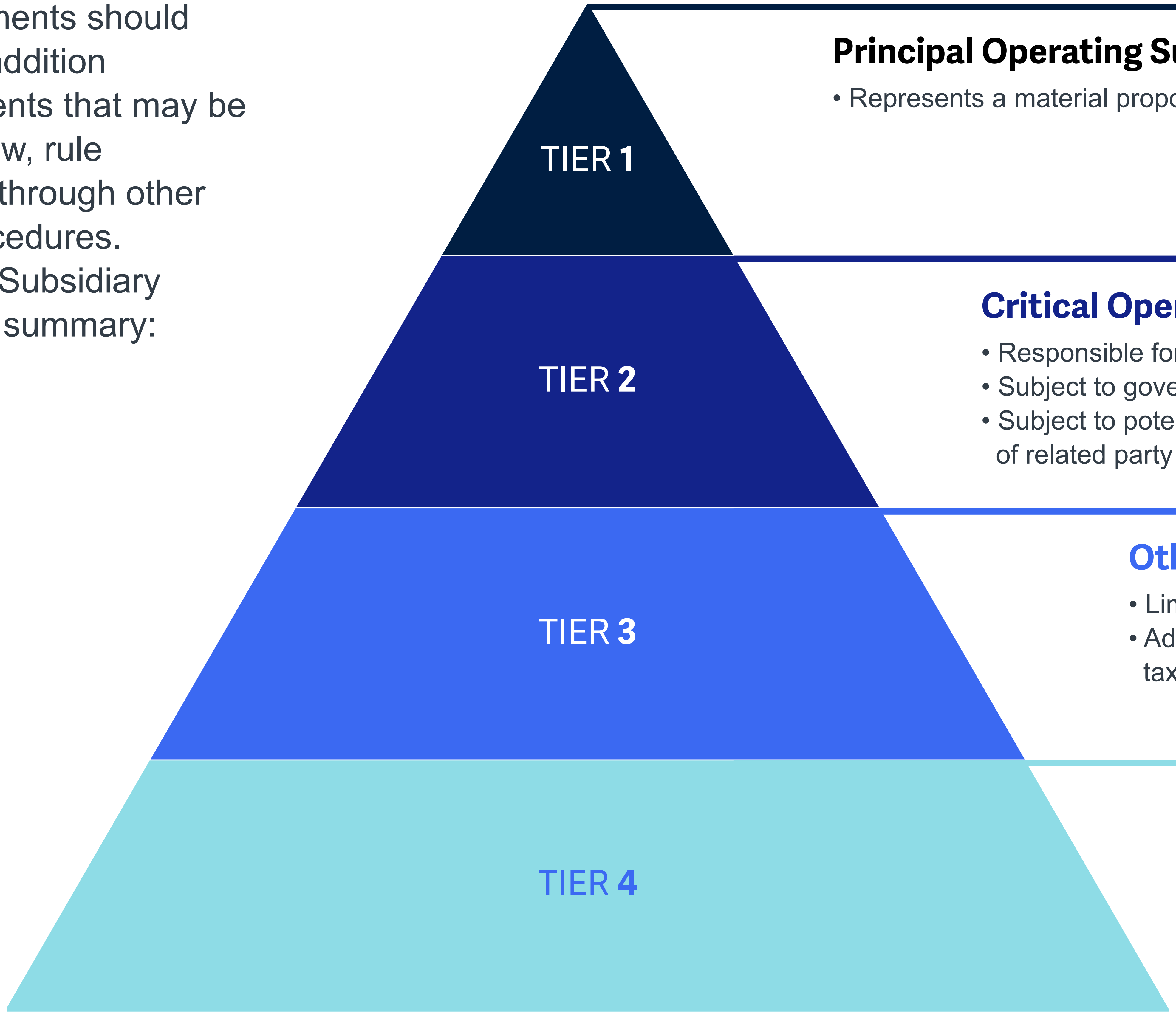
With legal, tax, and finance all executing components of subsidiary management, creating operational alignment on responsibilities, tasks, reporting, and ownership is critical to avoiding tasks from "falling through the cracks". One of the most common examples of a function that often has ambiguous ownership between legal, tax and finance in organizations is transfer pricing and intercompany agreements. Organizations with mature entity management functions have established a common understanding of the importance and facets of subsidiary entity management documented in playbooks, SLAs or Subsidiary Governance Frameworks.

The purpose of a Subsidiary Governance Framework is to establish a consistent approach for governance and set minimum standards for activities such as:

- Subsidiary to parent reporting content and cadence
- Financial and regulatory controls
- Guidance about formation, composition of subsidiary boards, appointment and termination of directors, onboarding, and training
- Guidance on how to conduct subsidiary board meetings and record minutes
- Procedures for incumbency and secretary’s certificates, powers of attorney, notarizations and apostilles
- Subsidiary director and officer training, indemnification, and signing authority.
- Compliance monitoring programs to ensure the framework requirements are appropriately satisfied
- Procedures for the ongoing review and maintenance of the intercompany agreements which are required for purposes such as regulatory, legal, transfer pricing customs and VAT / GST compliance

Example of Subsidiary Governance Framework

The Framework requirements should be consistent with or in addition to governance requirements that may be imposed by applicable law, rule or regulation or enacted through other company policies or procedures. Here is an example of a Subsidiary Governance Framework summary:



MORE OVERSIGHT

Principal Operating Subsidiaries

- Represents a material proportion of operations and risk

Critical Operating Subsidiaries & Intermediate Holding Companies

- Responsible for a key function of the enterprise
- Subject to governmental regulatory oversight
- Subject to potentially significant outside scrutiny, especially of related party transactions (taxation or minority interest)

Other Operating Subsidiaries & Holding Companies

- Limited or no operations/risk exposure
- Addresses a need, such as protection from liability, tax planning or residency requirements

Special Purpose Entities

- Created to address a specific need
- No operating oversight needed
- Requires minimal governmenance oversight

LESS OVERSIGHT

The sophistication of a Subsidiary Governance Framework should be relative to the complexity of the applicable subsidiaries. Some factors that contribute to complexity are:

- The size of the asset base
- Is the business operating in a regulated industry (e.x, healthcare, financial services, etc.)
- The subsidiary is client facing
- Prominence of the subsidiary's brand
- Number of employees
- Multiple business units
- Litigation exposure
- Wholly vs partially owned
- Jurisdictional requirements for independent directors
- Reporting requirements
- Whether entity is consolidated for financial statement purposes

CHAPTER 3

Why is Subsidiary Management important?

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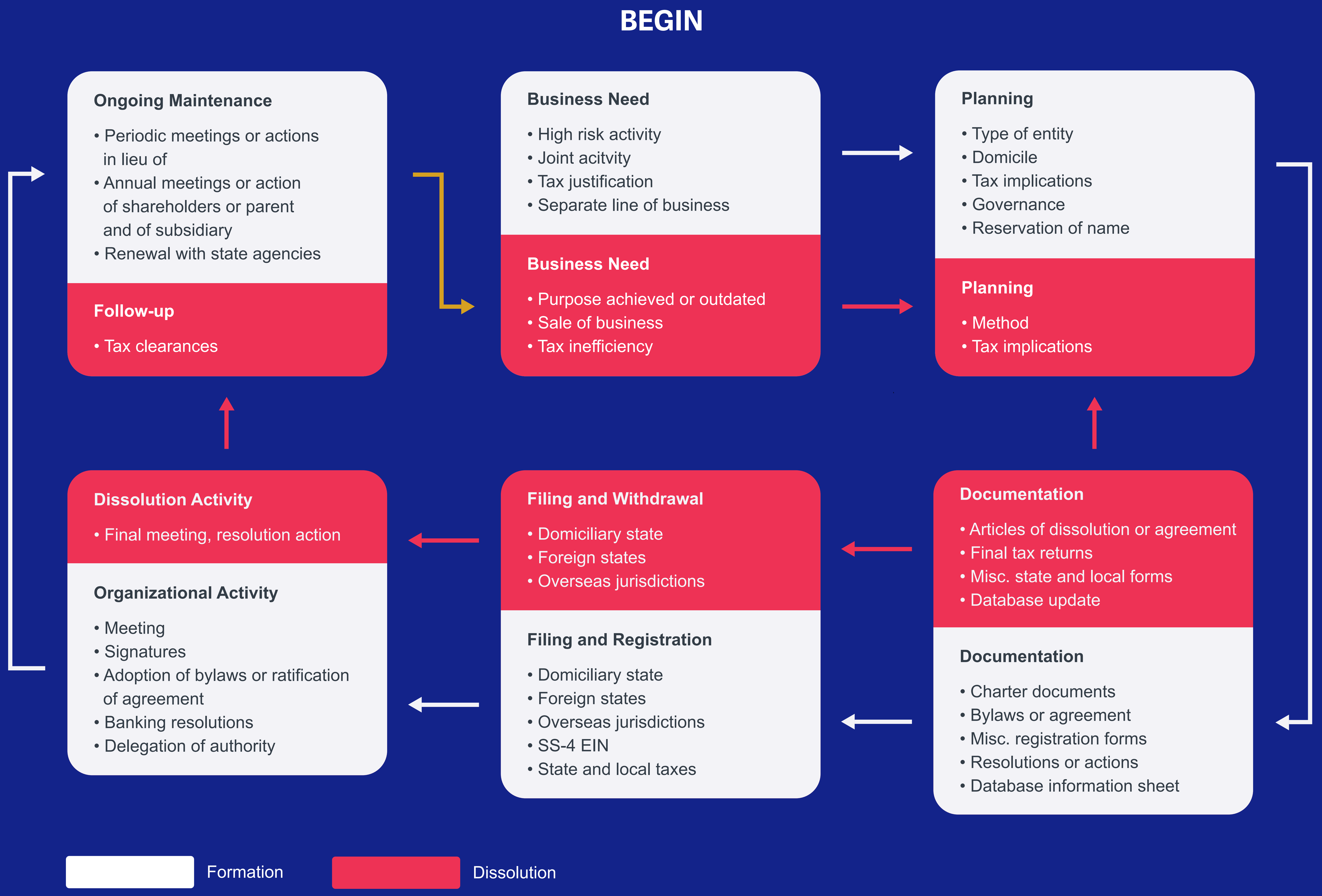
Aligning on the fundamental reasons for creating subsidiary entities across business units is important, which include:

- Establishing presence in a new jurisdiction (having a bank account, employees, tax IDs, contracting, etc.).
- Protecting a parent company's assets from liability for actions of a subsidiary company that it owns ("piercing the corporate veil")
- Being transaction ready to support friction on financings, M&A integration, divestitures, re-organizations, IPOs and other important corporate events
- Acting as guarantors and grantors of security if the parent compan must secure credit financing

The Life Cycle of Subsidiary

Cataloging the lifecycle of an entity and associated workflows can create a common understanding among legal, tax, finance, HR, and other stakeholders of the events that may involve them.

Here is an example chart outlining the events and actions in a subsidiary. This chart can be expanded to include the involvement of business units within the company.



Centralized Authority for Corporate Actions

The formation, maintenance, and dissolution of all company subsidiaries should be centralized in the legal department or corporate secretaries office to ensure effective governance and management. To reinforce this practice, the executive and the board of directors of the parent company should appoint the legal department as the central controller of subsidiaries, supported with necessary information management tools such as entity management software. When there is no clear ownership of the subsidiary entity management, tasks fall through the cracks and entities may become out of sync with the public record or get dissolved by the government due to missed compliance actions.

All companies should have a policy that identifies specific individuals in the business who have the authority to approve and execute corporate actions of various degrees of importance.

Delegation of Commercial Activity to Executive Management

The best practice is for the board of directors to adopt a policy that delegates routine commercial authority to the C-Suite executive team, including:

- Commercial transactions up to a certain dollar threshold
- Borrowing up to a certain dollar threshold
- Spending within the annual budget
- Hiring and firing of employees of a certain level of seniority

Delegation of Authority Policy

Together with the board of directors, the legal department should draft a delegation of authority policy which usually takes the form of a table that describes various commercial and corporate authority such as the ability to bind the company to insurance policies, commercial contracts, employment agreements, financial arrangements, and of course, forming and dissolving of legal entities.

CHAPTER 4

Data Governance in a Legal Entity Management Software Platform

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To maintain control over the corporate subsidiary structure, legal teams should operate a modern legal entity management software ("LEM") that centralizes all the critical data related to identity, ownership, control, tax, and compliance. A modern LEM allows legal to create unique profiles for each subsidiary that contains key information to enable reporting, workflow automation, and sharing, including:

- The entity's formation and organizational information (jurisdiction, date of formation, tax ID, registration number, etc.).
- The jurisdictions where the subsidiary is qualified to do business and related registration details.
- The subsidiary's parent company and any other shareholders, and the details of ownership (ex., certificate number, price paid per share, etc.).
- The subsidiary's directors, officers, powers of attorney, managers, and other authorized persons.
- Statutory due dates for annual shareholder and board meetings.
- The due date for the subsidiary's annual report, franchise tax, or statutory compliance fee.
- The registered agent, if the subsidiary uses an outside service provider.
- Tax information such as EIN numbers, tax elections (e.x., check the box).

Also consider who at the company needs access to the database and what data they are permitted to see or not. LEMs often contain personally identifiable information (“PII”) such as the birth dates, addresses, SSNs, and scans of identification, required by regulation for directors and officers verification purposes.

Most legal departments want to share access to the LEM to enable self-service of subsidiary entity data to business partners. However, to account for privacy and security restrictions, permissions should be applied to the data sharing to make certain restrictions, such as:

- Only authorized people in the legal, tax, or finance departments can update the database. Others should have read-only access.
- Any update to the database should have corresponding executed documentation such as resolutions, minutes, consents, filed government forms, etc.

In addition to permissions, another key benefit of a LEM is an audit trail that tracks all changes made to the LEM data, which user made the change, and at what time. This creates an immutable record to trace back errors in the corporate record. However, not all LEMs are made equal. In a 2021 report by EY, **96%** of General Counsel’s reported serious problems with their LEM. Learn more about the LEM market at this article:

EY Data Suggests Best-In-Breed Technology for Entity Management.

CHAPTER 5

Ongoing Management of Subsidiaries

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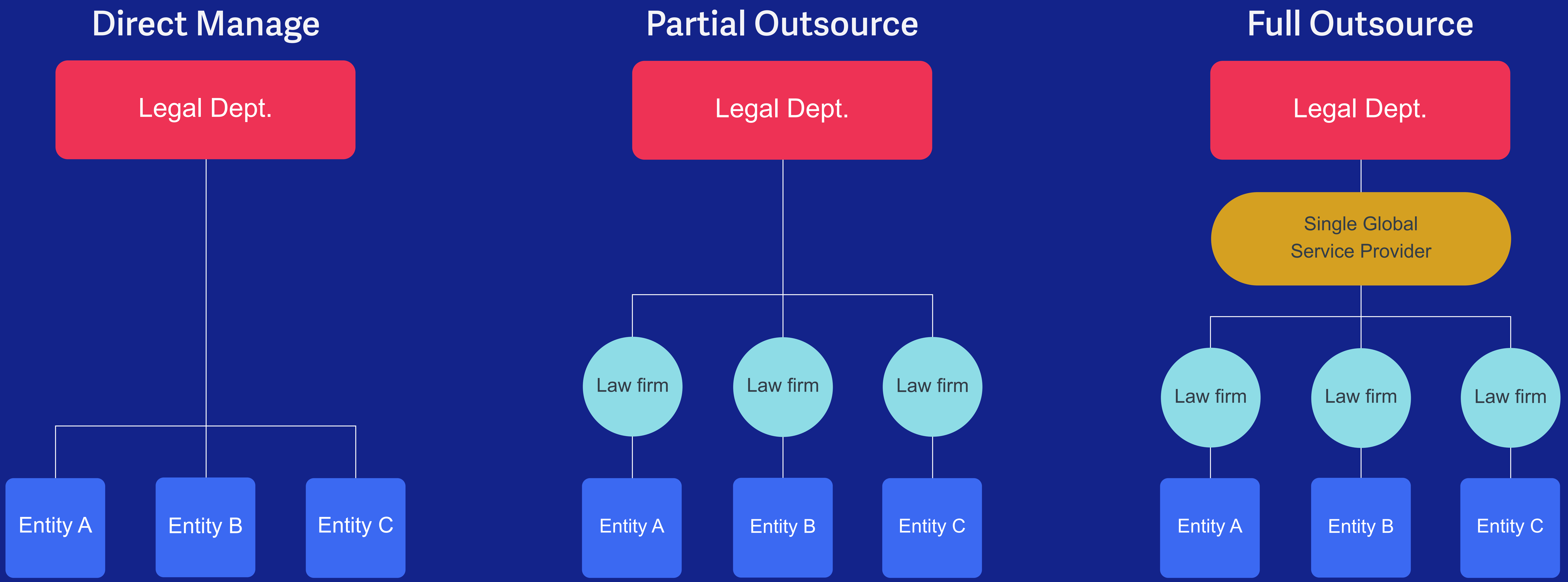
The complexity and effort to maintain global subsidiary entities that are in "good standing" and "deal ready" becomes significant as the corporate structure grows and expands across borders. There are three main configurations that legal departments use to manage their subsidiary entities: direct manage, partially outsourced, or fully outsourced. The appropriate configuration depends largely on the volume and complexity of your corporate structure.

3 Entity Management Models for Legal Departments



To learn more, visit our article: 3 Models for GCs to Outsource Legal Entity Management.

Good Standing: Compliance Calendars and Operations

To keep an entity in good standing with jurisdictions where it is registered, an entity must typically file an annual report and pay a statutory fee to the government in each jurisdiction where it is registered or qualified to conduct business.

Several dynamics compound to make annual reporting compliance complex:

- **What data must be reported?** Jurisdictions require different information to be reported. For example, some have minimal reporting requirements (typically only the directors and registered address/agent). While other jurisdictions require detailed ownership and financial performance information. This makes collecting accurate information for each jurisdiction in a timely manner complex.

- **When must the report be filed?** Most jurisdictions require annual reports. However, some jurisdictions require it only on the occurrence of certain events such as a change in ownership or governance control.

- **Who needs to file?** Some entities are exempted from filing annual reports. For example, in Delaware only corporations are required to file an annual report and pay franchise tax, while LLCs and partnerships only pay the statutory fee and are not required to file a report.

- **Who to submit the report to?** In some jurisdictions, annual reports and fees are to be submitted to the secretary of state or corporate registrar. However, in some jurisdictions it must be submitted to the revenue or tax collection department. This may determine who in the organization should file it (legal or tax).

- **Who has access to the filing system?** In many jurisdictions, governments gate access to the corporate registry to local service providers such as company secretaries, lawyers, or accountants in the jurisdictions. This requires the company to engage a local service provider to execute the filing and pay in voices.

A best practice is for the legal department to develop a compliance calendar or compliance operations system that keeps track of the above complexities for all its entities in each jurisdiction they are registered to conduct business. Most LEMs also contain compliance event calendar and management functionalities as well to create recurring compliance tasks, with reminders, and responsibility assignment.

CHAPTER 6

International Tax & Transfer Pricing Compliance – the Role of Entity Management

BY: **PAUL SUTTON**

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Transfer pricing compliance is a key tax risk area for any multinational group. Indeed it is often regarded as the single biggest tax risk for large corporates. In order for groups to manage that risk, it is not sufficient for them merely to adopt suitable tax compliance policies. They must also ensure that those policies are implemented in legal and operational reality.

This, in turn, requires groups to manage their legal entities effectively and to document the legal relationship between those entities through appropriate intercompany agreements.

Just to give one example: the US Tax Court's November 2020 decision in the case of Coca-Cola resulted in an estimated incremental tax liability of US$ 12 billion. The company's position in that litigation was significantly undermined by the fact that the tax positions it put forward were directly contradicted by the intercompany agreements which were in place between the relevant group entities during the relevant period. Even if the Coca-Cola company is able to overturn that decision on appeal, it will have been exposed to a significant cost and a drain on management resource, both of which could have been avoided.

What is Transfer Pricing?

Transfer pricing ('TP') is the international set of tax rules which determine the level of intercompany charges (e.g., service fees, royalties, prices for goods) which may be properly paid between associated entities within a multinational group, and which in turn affect where profits are made and taxed.

The OECD has adopted the arm's length principle as an international standard for determining transfer prices for tax purposes. In essence, the arm's length principle allows tax authorities to review the transfer prices affecting a particular enterprise, and then tax that enterprise based on the profits it would have made had the prices been negotiated between independent third parties. This applies both to ongoing supplies and to one-off transactions, and not just to legal entities, but also to branches or 'permanent establishments'.

This creates a risk of double taxation, because any adjustment of transfer prices in one tax jurisdiction implies that a corresponding change should be made in another jurisdiction. If the tax administration in that other jurisdiction does not agree to make that corresponding adjustment, the group may be taxed twice on the same profit. In addition, the group may be exposed to fines and penalties for deficiencies in its documentation.

What are ICAs?

Intercompany agreements define the legal terms under which transactions take place within a group of companies. These transactions can take many forms, for example:

- Head office and back-office services (e.g., finance, tax, legal, and HR services)
- Marketing services
- R&D services
- IT services and support
- Shared services arrangements
- Sale of goods
- Sales agency and commissionaire arrangements
- Intellectual property licenses
- Revenue/profit sharing
- Cost-sharing
- Contract manufacturing
- Toll manufacturing
- Loan facilities (e.g., term loans, revolving credit, and overdraft facilities)
- Intercompany debt in security form (e.g., loan notes)
- Guarantees and other forms of security or financial support
- Cash pooling
- Secondment of staff and other mobility arrangements

The Importance of ICAs in Transfer Pricing Compliance

Multinational groups must adopt appropriate policies for transfer pricing compliance, including which intercompany charges are made between group entities, and how those charges are calculated. This, in turn, is reflected in the local tax filings for each of the legal entities and establishments (branches) of the group. Intercompany agreements perform a key role in implementing those policies in legal reality. This includes:

- Describing or 'delineating' the transactions – for example, documenting which services are provided or intellectual property is licensed.
- Allocating contractual risk between the parties – for example, specifying which party bears risks such as product liability claims, credit risks, currency risks, or inventory risks (the risk that stocks of products may not be sold).
- Specifying the price or fees to be paid by the relevant parties – such as the calculation of royalties or license fees.
- Specifying which party owns intellectual property rights used or generated in connection with the arrangement – such as improvements to technology.

Copies of ICAs are often one of the first items which tax administrations will ask for in a tax audit or tax inspection. If the ICAs don't match the group's transfer pricing policies or tax filings, the group is immediately on the back foot. At the very least, this is likely to prolong the tax audit, and it undermines the credibility of the group's tax compliance position as a whole. In short, ICAs are a fundamental part of transfer pricing compliance for multinational groups.

Defects in ICAs

Some problems that often occur in ICAs are:

- An ICA that contradicts the allocation of risk described in TP documentation, meaning that historic filings are inaccurate.
- Overly long agreements that use legalese language. These contain administrative provisions that are not followed in practice and/or are incorrectly structured. This causes friction when trying to get the agreements reviewed by the proper parties, resulting in incorrect reporting.
- Gaps in the intercompany transaction types covered by ICAs so that certain transactions are not legally documented at all, leaving risk allocation and price open to the interpretation of tax administrations
- Unsigned, undated, or incomplete agreements.
- Agreements that are not centrally archived.
- Agreements which have not been updated to reflect revised benchmarking or revised TP policies and models.
- Failure to integrate newly acquired or incorporated legal entities.
- Over-reliance on local tax managers to maintain files of signed intercompany agreements, with no assurance that they are complete, and no contingency plans in place if those managers are unavailable or have left the group.

Some consequences of these defects are:

- Fines and penalties, simply for failing to produce signed ICAs when requested.
- Disallowed expenses.
- Post-year-end 'true up' or 'true down' adjustments may be rejected.
- Local tax authorities may be more likely to attempt to re-characterize a transaction as something other than that claimed by the taxpayer.
- Groups may be subject to adverse transfer pricing adjustments and associated fines and penalties.

Effective ICAs

In order to be effective, ICAs must be:

- Aligned with the allocation of functions, risks, and rewards described in transfer pricing policies
- Legally binding
- Correctly signed and dated on behalf of all the participating entities
- Kept updated on a regular basis, so that they continue to provide an appropriate legal framework for the group's TP policies, corporate structure, and operations as they evolve
- Appropriately archived so that they can be quickly accessed when required.

It is also critical to know that intercompany agreements should not merely be consistent with the group's transfer pricing policies but also its regulatory objectives and the day-to-day practices and operations.

Maintaining Effective Audit-Ready ICAs

Over time, a company may restructure through acquisitions, organic growth, or other reorganizations. These changes can result in new business models, functions, ranges of products and services, value drivers, and market conditions. If intragroup supplies alter in any way, the group may need to change its ICAs or create new ones. Changes in tax legislation may also require the group to update its transfer pricing compliance strategy. This requires constant maintenance and monitoring.

A typical process for maintaining intercompany agreements follows five key stages: scoping; review; drafting template ICAs; finalizing the template ICAs; and implementing the template ICAs. It is important that those five stages are repeated periodically (typically once or twice a year). All the previous work is wasted if, when ICAs have to be used, they are out-of-date and therefore useless.

This process can be fully managed by an outsourced law firm. The result is a centrally archived suite of documents that are available at short notice to respond to TP or tax audits.

About **Athennian**

Athennian's corporate entity data management software is used by hundreds of top law firms and in-house legal teams, to manage all their entity data within a single platform. Athennian's cloud-based platform makes entity management more efficient by building in automation, customizable workflows, dynamic reports, and self-serve digital experiences.

Visit **www.athennian.com** to learn more.

Adrian Camara

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Adrian is a Toronto/Calgary based entrepreneur and lawyer. He was educated at Glendon College (BA, History), and the University of Western Ontario (JD, Law). Adrian worked at McCarthy Tétrault LLP prior to founding Athennian with a team of artificial intelligence engineers in 2016. He is a frequent speaker on panels discussing the intersection of law and technology.

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Paul is a co-founder of LCN Legal, a law firm specialising in corporate structures and intercompany agreements for multinational groups globally. He is the author of the leading book on this subject, namely 'Intercompany Agreements for Transfer Pricing Compliance – A Practical Guide.' Readers can download a free copy of LCN Legal's 'Guide to Effective Intercompany Agreements' at www.lcnlegal.com.