

# Best Practices in Tax Planning

**Corporate scandals and proposed regulations place CFOs at the forefront of tax planning strategies.**  
by Fay Hansen

**T**HE UNEVEN RECOVERY IS PLACING pressure on companies to continue cutting costs, including spending on taxes. This imperative coincides, however, with greatly increased scrutiny of tax filings at every level of government. Identifying tax-reduction opportunities without jeopardizing a company's legal status and reputation is more difficult today than ever before. And it's even more complex for the increasing number of companies that rely on revenues pulled from operations abroad.

In the context of recent corporate scandals, the notion of "tax planning" has taken on dark overtones. "But tax planning is not, per se, a bad thing," says David W. Zimmerman, a partner with PricewaterhouseCoopers in New York City. "To the extent there are supportable positions to reduce taxes, and after considering any perceived adverse impact from implementing such strategy, the development and implementation of prudent tax planning strategies could, in fact, be considered good governance."

To ensure that cost savings measures won't result in problems for the business, tax managers must fully vet tax-planning strategies across the entire management team. This need has generated one of the most visible changes in tax planning in recent years: the substantial expansion of the number of individuals involved in



the process. "The principles of good governance over a company's tax planning function currently extend to the entire 'C suite' — to include not only the CFO, but also the COO; general counsel; and, in many cases, the CEO," says Zimmerman. Tax oversight also extends to the audit committee.

All levels of the enterprise need to commit to taking the steps necessary to guarantee complete and accurate tax compliance and reporting. "For some organizations, those steps might be major initiatives, such as introducing or expanding the use of automation within tax departments to smooth the reporting process for internal controls," explains

Steven K. Rainey, partner in the federal tax practice for KPMG LLP in Tysons Corner, Va. "For others, it could be something as simple as addressing the tax elements of a new business venture, new location or new product from the very beginning of the process."

According to Zimmerman, the most critical best practice in tax planning is ensuring that the "tax tail does not wag the dog." He explains, "More simply stated, the financial or operational strengths of a business transaction must stand on their own, aside from the tax benefits that may be derived from them." In addition to evaluating the legality and appropriateness of proposed

tax strategies, the CFO must make certain that the audit committee and other members of senior management have the opportunity to address the potential business implications of those strategies, Zimmerman notes.

Finance executives may also want to become tax-planning advocates before their company's full board. "The CFO has an opportunity to act as a change agent for the overall good of the enterprise by helping to make tax a boardroom issue," Rainey says. "He or she should lobby for a regular position on the board's agenda to report on tax issues and their impact on the bottom line, ranging from the company's use of permissible tax exemptions to the tax impact of various executive compensation packages. The pervasiveness of tax in an enterprise's operations requires that the board be updated regularly on tax issues. Now is the right time to bring these items to the board's attention, in the new regulatory environment."

### Developing a Tax Plan

To come up with the most comprehensive tax-savings solutions possible for their company, CFOs should ask all members of the tax department to contribute their own planning and cost-reduction ideas. "This results in the CFO viewing the tax department as a business partner that not only delivers the services of filing returns and hosting audits, but also contributes a few pennies per share to the P&L," says Dave Leifer, director of emerging tax issues at Vertex Inc., a tax-software provider in Berwyn, Pa.

Before presenting their department's suggestions to the CFO, tax managers should assess the complexity of the plan, its benefits and risks, and the resources required to execute it. Once the CFO is on board with the plan, "the company must establish a method to measure the success of the plan by setting a numeric tax-savings goal," Leifer says.

He identifies four criteria for effective tax management:

## Tax Implications of Transfer Pricing

Tax departments devote substantial resources to transfer pricing – setting prices on transactions that occur between corporate divisions located in different jurisdictions – and their efforts are coming under scrutiny. "The IRS wants to make sure that the [multinational] group is not paying too much money to low-tax jurisdictions from higher-tax jurisdictions," says Philip R. West, partner with Steptoe & Johnson LLP in Washington, D.C. The transactions affected include intragroup sales of goods, intragroup financing, and intragroup transfers and licenses of intellectual property.

"Because pricing is as much art as science, you can't be expected to get the price right, down to the penny," notes West. "But if your documentation doesn't show that your prices are at least within a middle range of prices that are charged in comparable transactions between companies that are not related to each other, watch out for penalties." To complicate matters, foreign governments may have different documentation requirements and penalties that apply to the same transactions.

On the other hand, because there is no single correct price for any transaction, transfer pricing can represent an opportunity. "You may not want to risk tax penalties by being overcharged by a low-tax affiliate, but if you're being undercharged by that affiliate, you may be leaving money on the table for Uncle Sam to swallow up," West says. "The moral of the story is to be like Goldilocks. Make sure your prices aren't too large or too small; try to get them just right."

**1. Strategic tax planning** depends on a sound methodology for preserving the company's assets. Executives who are involved in the tax-planning process should determine the best way to organize legal entities, research issues that can result in tax savings and set goals for the company's effective tax rate.

**2. The right technology** is essential for increasing the effectiveness of a tax department. Integrating various reporting systems with a tax database can automate and centralize information, which allows for faster data access. All systems must address the need for security, audit trails, and rapid response to changes in both the company and tax laws.

**3. Regular examinations** of the tax plan enable a tax department to prepare for future audits. The tax group needs to be able to determine the impact of an audit assessment on the company's earnings. The group must research tax issues before they materialize and stay current

with changing tax law to ensure that the company's position is accurately and consistently communicated to auditors and stakeholders.

**4. To improve efficiency**, the tax group should constantly seek new ways to streamline the filing of returns, while maintaining the quality and accuracy of the information. Reducing the time and cost of ongoing compliance efforts lets tax professionals concentrate on the value-adding areas of audit, planning and technology.

### International Considerations

Intense globalization has pushed international tax planning to center stage for many companies. "The best practice in international tax planning focuses on the tax-effective structuring of ongoing business operations and major corporate transactions, as opposed to one-off tax 'products' that do not fit nicely with a company's business operations or may have nothing at all to do with real busi-

## Integrating International Tax Planning

International tax planning should be integrally woven into corporate activities, advises J. William Dantzler Jr., a partner with White & Case LLP in New York City. “A tax plan should never be just tacked on as an afterthought or bolted awkwardly on the side of a business or transaction,” he says. Dantzler advises executives to achieve integration by following eight basic steps:

1. **Seek competent tax advice in every relevant jurisdiction.**
2. **Communicate all the facts to each tax adviser.** Tax conclusions are often based on fine distinctions among facts.
3. **Appoint a single in-house or external tax adviser as the point person who is responsible for coordinating and reconciling the advice from the various jurisdictions.**
4. **Make sure the plan fits the business.** Sophisticated cross-border tax planning cannot be bought off-the-shelf.
5. **Capture all of the tax analysis in writing to serve as a guide for future tweaks and revisits.**
6. **Be very careful with the documentation of transactions.** The audit battle is often won or lost based on the documents.
7. **Obtain a high-quality legal opinion from first-rate counsel for any high-stakes position that falls into a gray area or could be considered aggressive.**
8. **Consider how you and other executives would feel if your tax planning appeared in the local newspaper.** If what you are doing might embarrass the company, don't do it.

“Of these steps, numbers four and eight are the ones most frequently omitted – and the most likely to lead to trouble if they are not followed,” Dantzler says.

ness or investment operations,” says John Peterson, partner and chair of the global tax practice at international law firm Baker & McKenzie in Palo Alto, Calif. “This often means centering ownership of capital, ownership of IP [intellectual property], and risk in tax-advantageous locations.”

Under the U.S. tax system and the systems of most of the United States' major trading partners, companies have wide latitude in how they structure operations, including intercompany legal

relationships. “The best international tax planning starts with an understanding of the company's operational goals and where flexibility lies as to location of people and facilities, and attempts to accommodate those goals in a tax-effective fashion,” Peterson advises. Although the CFO has always needed to understand and set the tone for the company's international tax planning strategy, “after the events of the last few years, this is more important than ever, as the CFO has become the major intersection between

the company's tax planning goals and strategies,” Peterson says.

Auditors still must review the effects of tax planning on the company's tax bill. “But in this new era of greater investor concern about corporate governance and auditor independence — and the U.S. Sarbanes-Oxley legislation and similar rules emerging abroad — it is probably no longer a best practice to have the auditors as the primary outside tax adviser helping develop tax planning strategies that will have a major impact on the tax provision,” Peterson warns.

### Tax Planning for M&As

Merger and acquisition (M&A) activity dropped so sharply during the downturn that it all but vanished as a consideration in the tax-planning process. But the recent revival in these deals has put them back on the tax agenda. “Domestic M&A transactions should always have a dual focus: risk and minimization,” says Gary Pompan, a partner with Ernst & Young LLP's transaction advisory services practice in New York City. “First, one must focus on identifying historical tax risk that could be inherited as part of the transaction. Second, you have to minimize the cost inherent in the execution of the transaction to all the participating corporations and shareholders. That's true post-transaction, too.”

Federal tax costs have historically been the primary focus in domestic M&As, but state and local taxes are increasingly becoming companies' main concern. “In a transaction, these taxes can be significant and in many cases — particularly on an ongoing basis — can impact a company's EBITDA,” Pompan notes.

Cross-border deals, also on the rise after years of decline, have profound implications for tax planning. “The key principles in structuring a cross-border transaction in the current complex, multijurisdictional tax environment are coordination and integration,” Pompan says. “These are concepts that equally apply to business operations, culture and taxes. Cross-border transactions, like

most other transactions, have the basic goal of minimizing the tax upon the acquisition and following the acquisition. However, it is the latter goal in the cross-border scenario that requires the investment of thought and time.” Companies must explore their alternatives for directing investments into and obtaining financing within various jurisdictions.

Rate arbitrage has always been the guiding principle of cross-border tax planning. This is particularly true in an acquisition. “As foreign taxing jurisdictions have continued to modify their tax rules and the U.S. has continued to refine its rules, the structuring of a cross-border transaction becomes somewhat like a game of chess,” Pompan explains. “The use of hybrid instruments — those viewed as debt or equity in one jurisdiction and just the opposite in another — are still key in acquisitions to maximize interest deductions. Thus, choosing the appropriate jurisdiction through which to deploy a foreign acquisition is important from a characterization-of-instruments perspective.”

### **New Regulations Ahead**

The IRS and the Treasury Department have expended substantial effort in recent years to rein in the proliferation of heavily marketed tax products. “The most important government initiatives to date are reflected in two sets of Treasury

regulations: the disclosure and the list-maintenance regulations,” says Herbert N. Beller, tax partner with Sutherland Asbill & Brennan LLP in Washington, D.C., and immediate past chair of the American Bar Association Section of Taxation. Tax filings that involve a “reportable transaction” require a special form that provides information about the structure and tax treatment of the transaction and identifies any outside tax advisers or promoters who were involved in the transaction.

Currently there’s no penalty for failing to disclose a reportable transaction, but Beller expects stiff penalties to soon be enacted. Proposals in Congress call for substantial new statutory penalties — as high as \$200,000 — for failure to report any transaction that is subject to the disclosure and list-maintenance regulations. In addition, Treasury Department proposals “would require denying interest deductions for tax deficiencies arising out of most reportable transactions, extending the period for assessing tax on undisclosed reportable transactions from three to six years, and imposing a \$50,000 penalty on ‘material advisers’ who fail to file a detailed IRS information return regarding any reportable transaction in which they are involved,” Beller reports. “All large and midsize corporations need to have internal systems for identifying reportable transactions and monitoring

and gathering the information that will have to be disclosed. This normally will require close coordination between the company’s tax, accounting/treasury and legal personnel.

“Also on the tax-opinion front,” Beller continues, “Treasury recently repropose regulations under Circular 230, which governs practice before the IRS, setting forth stringent factual and legal diligence standards that tax advisers must adhere to. From the client’s perspective, the heightened diligence requirements will usually require more time and thus result in higher fees.” Another hotly debated proposal would mandate that CEOs sign corporate tax returns. And any additional action Congress takes with respect to tax shelters could call into question many businesses’ approach to international tax planning.

“In the years ahead, I see more strict internal controls; a tightening of exemptions and loopholes as states and localities seek new revenues; and more Web-based, streamlined tools and processes for analyzing, forecasting and researching taxes to coincide with further globalization,” Vertex’s Leifer predicts. Finance executives will need to continue to identify tax-saving strategies, but within an ever-stricter set of rules.

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