

# Update from the Front: Current Issues Affecting Corporate Tax Departments

By Giles Sutton

For a number of years, corporate tax departments have been stretched thin by an increased emphasis on financial tax accounting, rapidly changing tax laws, the advent of tax shelter rules, more aggressive tax authorities, and a focus on outsourcing. The economic downturn has intensified these pressures through headcount reductions and restricted training budgets. Further, renewed attention on tax planning has forced tax departments to do even more with less. This article reflects conversations with in-house tax executives across the country and explores how tax departments are dealing with these competing, and sometimes conflicting, issues.

## Headcount Management

Doing more with less has been a mantra within corporate tax departments for years often causing corporate tax departments to simply fall victim to corporate edicts regarding headcount reduction. Despite the recent downturn in the economy, many tax departments have been successful in resisting such headcount pressures. Why? Corporate tax departments have been understaffed for years. In addition, tax department heads have acquired more visibility recently within corporate America better positioning them to challenge these pressures. Arguably, this increased visibility partially resulted from the passage of the Sarbanes-Oxley Act of 2002, which brought increased visibility to the complex processes tax departments must manage, and the advent of FIN 48, which highlighted the amount of risk for which tax departments are responsible.

There has also been a wide-spread acknowledgement that the number of people leaving the tax profession has exceeded those entering it. This is owing to a number of factors, including the instability occasioned by tax department consolidations following mergers and acquisitions; the increasing complexity of tax laws; and greater workload pressures on corporate tax departments. The result seems to have been a realization by senior management that the “survivors” within their tax departments are highly trained professionals and that, if layoffs are made (or retirement packages offered), suitable replacements will not be readily available.

Notwithstanding the immunity of some tax departments to general corporate staffing reductions, others have suffered (and continue to suffer) through the loss of key tax department personnel caused by layoffs and attrition. Rarely, however, do these resource reductions correspond to a lessening of the tax department’s responsibilities. The confluence of increased tax management responsibilities and reduced staffing challenges even the most accomplished tax executives.

## Process Efficiencies

“Doing more with less” is essential within corporate tax departments and creating process efficiencies can maximize each department’s effectiveness by minimizing duplicative work. Much of the information used in the tax department serves more than one purpose. For example, data collected to calculate a corporation’s tax provision also serves as the basis for reporting book-to-tax differences on Schedule

M-3 of the entity’s U.S. federal tax return. Corporate tax departments have been trying to ensure that tax data does not have been requested more than once or manipulated by different individuals in a duplicative manner. Therefore, tax departments have tried to streamline their processes from provision preparation, to federal tax return preparation, to state return preparation — building in FIN 48 documentation and tax planning support to the process.

For example, tax departments have invested in more robust tax software to integrate tax provisions with tax compliance and planning. Tax departments have also developed detailed, and comprehensive, departmental business plans to focus the deployment of tax department resources on designated value-added goals. Furthermore, there has been an increased focus on integrating tax department goals and Information Technology (IT) resources. This reflects a realization that much of what tax departments are asked to accomplish is heavily dependent on the availability of IT resources. These efficiency efforts, combined with better upward feedback from tax departments to senior management, have led to better management of expectations for corporate tax departments.

## Outsourcing Analysis

As tax departments struggle to meet their responsibilities efficiently and effectively, the issue of which functions to outsource — as well as how much of a given function to outsource — has again entered the discussion. The desire of corporate America to explore tax department outsourcing seems to come and go, and the recent economic downturn has started another cycle of outsourcing analysis. Such discussions often put tax department leaders on the defensive, with corporate management’s default view likely to be that any objection to outsourcing is simply tax department “turf protection.”

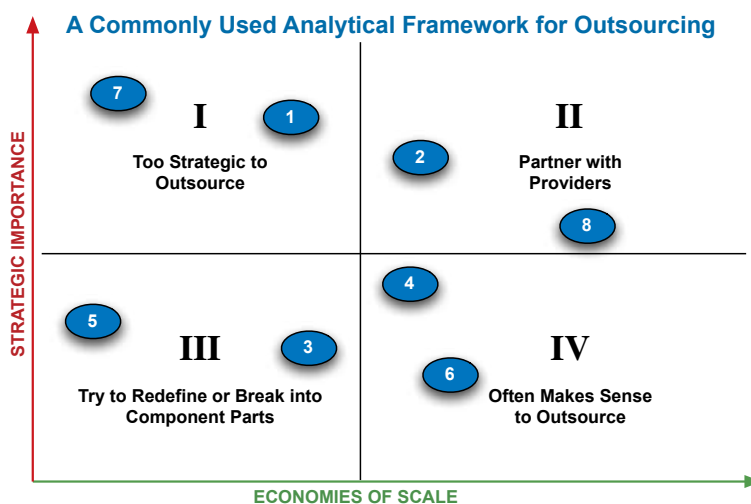
Corporate executives are usually quick to jump to conclusions about the benefits derived from reductions in payroll costs and too quick to believe the heady promises of efficiency and effectiveness made by outsourcing providers. The reality, of course, is that tax outsourcing decisions, to be effective, require a complex and unbiased analysis. Decades of experience demonstrate that outsourcing can be a “penny wise and pound foolish” experiment. Obsessing on headcount reductions or promises of “seamless” services has been counterproductive from both a cost and a risk management perspective. A strategic approach to corporate outsourcing is needed, but the construct for an effective and objective analysis addressing corporate outsourcing has been elusive.

Corporate tax departments must balance the strategic importance of the tax function against the potential cost savings of outsourcing the various tasks necessary to execute that function. This framework allows both the tax director and upper management to remove emotion from the equation by introducing a more objective, dispassionate management-oriented measurement. Frequently, the analysis seeks to assign tax department tasks to one of four quadrants based on relative strategic importance of the function and whether there are economies of scale inherent in outsourcing the function. The resulting grid creates four quadrants

into which tax department functions fall: (1) too strategic to the organization to outsource; (2) functions that are strategic but lend themselves to economies of scale; (3) functions that are neither deemed strategic nor subject to economies of scale; and (4) operations where economies of scale clearly determine the cost of the function to the organization.

In the context of this analysis, senior corporate management and tax departments have sought to:

- Identify those tax department functions that are viewed as strategic, and keep them in-house;
- Outsource those non-strategic tax department functions where economies of scale drive cost efficiencies;
- Partner with vendors where there is some blend of strategic importance and economies of scale; and
- For those functions where there does not appear to be significant strategic importance or economies of scale, attempt to redefine the task at issue in order to make a solid “own,” “out-source,” or “partner” decision.



● = Task Number

### Training and Cross-Training

For tax departments, a key challenge has become keeping up with rapidly changing tax laws and technical demands at a time when travel and training budgets have been slashed. This conundrum has spawned much creativity within corporate tax departments, including utilizing more on-line training, finding opportunities for in-house training, and seeking to cross-train within the department. In particular, cross-training has meant more training between functional areas such as planning and compliance, sales tax and income tax, and tax accounting and tax compliance.

To facilitate in-house training, companies have charged members of the tax department with monitoring tax issues and related law changes of particular importance to the industry, or industries, in which the company operates. In addition to keeping current on relevant developments, this cross-training effort supports the process streamlining that tax departments have been asked to accomplish.

### Audit Management Efficiencies

Managing audits by tax authorities can be extremely time-consuming

for tax departments. Particularly in the state income tax area, where states have become increasingly aggressive, audits can drag on for months and can be a drain on tax department resources. In response to this trend, corporate tax departments have attempted to expedite the audit process through two primary means: (1) quickly identifying the material audit issues; and (2) attempting to arrive at acceptable settlement positions for those issues. Specifically, tax departments must determine specific settlement ranges (where such ranges are ascertainable) and accurately calculate the financial statement reserves that will be necessary during the pendency of the controversy. For those audits which cannot be settled through administrative processes, more efficient litigation management becomes necessary. In particular, finding competent counsel and managing the tax department’s investment of time and resources in trial or settlement preparation is important.

### Entity Rationalization

Many companies have utilized entity-based tax planning that is now subject to increased scrutiny by tax authorities. Past or prospective acquisitions also frequently put tax departments under pressure to simplify post-acquisition structures. These pressures emanate from a variety of sources, including a desire to eliminate special purpose entities that do not have a non-tax purpose; better manage tax department time in defending minimally effective structures; and reduce the compliance and documentation burdens of the tax department.

Businesses have used various structures to manage their international, federal, and state tax liabilities. For example, in both the state and international context, many companies moved their intellectual property into a separate legal entity located in a favorable taxing jurisdiction. Pursuant to intercompany royalty agreements, entities operating in high-tax states or nations accrued royalty expenses reducing their tax base and associated tax liabilities. The entities holding the intangible assets recognized royalty income, but often paid little or no tax on that income resulting in a net reduction of the corporate group’s overall tax burden.

States have employed numerous weapons to attack these structures. Some states have passed combined reporting statutes that require most (often all) related corporate entities to file a single group return that eliminates intercompany transactions — including royalties — in the calculation of the group’s tax liability. Other states have acted administratively expanding the range of contacts with the state that create a tax filing requirement to include the use by others of the out-of-state entity’s intangible property in the state (i.e., so-called economic nexus). Still more states have enacted legislation to deny corporate deductions for royalties paid to related corporations. These state actions have eliminated many tax benefits of these structures creating a renewed focus on structure simplification. Simplifying corporate structures can also have significant benefits to a tax department. Reducing the number of legal entities reduces the business’ compliance costs (tax, legal, and accounting compliance costs), and the number of entities that could be audited by tax authorities.

### Issues Raised by Entity Rationalization

From a tax perspective, the liquidation, merger, or other transformation of legal entities creates issues that must be analyzed before the execution of any restructuring plan. In particular:

- Solvency — In order to qualify for tax-free treatment under I.R.C. § 332, an entity being liquidated must be solvent. A failure to meet this requirement can trigger unexpected tax gains.
- Liabilities in Excess of Basis — If contributions are being made to existing entities, taxable gains can result when the liabilities transferred exceed the basis of contributed assets (I.R.C. § 357(c)).
- Distributions — If distributions will be made within the corporate group, beware of the distribution of appreciated assets which can create taxable gains to the distributing corporation (I.R.C. § 311(b)).
- Partnership Contributions — If assets are being transferred to captive partnership structures, be aware of deconsolidating assets having associated deferred intercompany gains (DITs).
- Partnership Terminations — If the ownership of existing partnership structures is changed, be aware of technical terminations (I.R.C. § 708 — depreciation restart).

For a domestic group, the following related state income tax issues must be considered:

- Whether separate entity gains be triggered (still an issue in separate entity states).
- California deferred intercompany stock account (DISA) rules (similar to deferred intercompany transactions in the federal consolidated return context).
- When entities are collapsed, will state tax attributes (NOLs, capital losses, or credits) be lost.
- State specific short-period return rules.
- Will the nexus or apportionment profile of the organization be changed?
- How will intercompany account balances be settled or affected.
- Real property transfer tax issues — often affecting transfers between related entities; and sales tax implications of (1) asset transfers, (2) inventory transfers, and (3) registration issues.

In the current environment, when state budget deficits loom large and state auditors have become more aggressive, ensuring that these issues have been addressed properly is at a premium.

### Common Entity Structure

Often, forces outside the tax department force certain entity structural decisions to be made. Those forces can be economic decisions affecting the broader organization (such as regulatory, legal, and financing constraints), or resource constraints within tax departments (such as the ability to file additional returns, account for intercompany transactions, or defend unintuitive structures on audit). To the extent that entity structures are reorganized or “simplified,” tax departments have worked to align new entity structures in accordance with enterprise value drivers. These structures are frequently based around key operations such as supply chain management, research and development, or, for service businesses, the cost of performance.

Such realignments clearly take into account transfer pricing realities including a new, and somewhat jaded, view of the certainty provided by transfer pricing. Many states, such as Massachusetts, chafe at certain common transfer pricing techniques (such as the “residual profit split” method) and will not necessarily respect taxpayer deter-

minations, even if the methodology is compatible with section 482 of the Internal Revenue Code. Other jurisdictions, such as the District of Columbia, are hiring (or contracting) with data-mining firms to develop “comparables” that could be used to challenge taxpayer determinations. This “new reality” in transfer pricing has recognized the questionable reliance that can be placed, at least for state income tax purposes, on such studies in certain states.


### Planning Is Back

Interest in corporate tax planning ebbs and flows depending on how corporate management views the tax function in the context of overall risk management. Not surprisingly, in light of the sputtering economy, tax planning has regained favor. For many companies, tax planning has moved from a “best practice” to an operational imperative reflecting an intensified effort to reduce the costs of doing business. Driving this renewed interest in planning is the need to manage cash and increased benchmarking within industries. In this context, planning seems to be focused on a balancing of three factors: economic benefit, technical risk, and the tax department effort required set up and maintain any new entities or transactions. How each company defines and evaluates these factors may differ, but typically, not widely. Therefore, planning efforts that meet these criteria have been widely adopted.

The tax planning now in vogue includes tax accounting strategies that keep meaningful amounts of cash on the balance sheet, operational tax savings providing “above the line” benefits, and ideas that lead to permanent savings, particularly, in the state tax area.

With the economic recovery expected to be slow, the corresponding slow growth in revenue for most companies will mean a continued focus on tax planning in the foreseeable future.

### Conclusion

Tax departments are facing a new and very challenging environment. Tax departments have gained greater visibility in recent years. This has increased the influence tax departments have on their own futures but also creates pressure to both operationally manage and define tax planning best practices. “Doing more with less” alone, is not sufficient. In this context, tax planning has become more of a focus, not as a replacement for risk management, but now in conjunction with risk management. Further, with increased pressure on outsourcing, the tax department’s analysis of related issues is expected to be rational, practical and candid. In today’s environment, tax executives are expected to be not just tax technicians but process and risk managers. Tax executives must be prepared to sit at the table with corporate leadership as effective participants in strategic planning. 

*Giles Sutton is a partner in the State and Local Tax practice of Grant Thornton LLP, and leads the firm’s State and Local Tax Technical Services Practice. Resident in the firm’s Charlotte, North Carolina, office, he received a B.A. degree from DePaul University, M.A.S. degree from Northern Illinois University School of Business, J.D. degree from Northern Illinois University College of Law, and LL.M. degree in Taxation from Georgetown University Law School. Mr. Sutton is a member of the Tax Section of the American Bar Association, the Kentucky Bar, and the American Institute of Certified Public Accountants. He may be contacted at: giles.sutton@gt.com.*