

Strategic Corporate  
**tax planning**

JOHN E. KARAYAN  
CHARLES W. SWENSON  
JOSEPH W. NEFF



John Wiley & Sons, Inc.



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# introduction

**T**his book shows managers the principles of tax management and how to apply them to every day situations to enhance shareholder value. (The book also shows professional advisors how to become more effective consultants, and investors how to better analyze financial statements.)

Taxes are important to know, but hard to learn. The devil is in the details. But managers and investors do not need to know the details. They just need to be aware of the fundamental principles of taxation and how to apply them when making decisions.

Even this is no simple task. We have tried to do this in two steps. First, over 75 years of experience have been distilled into an innovative framework that organizes tax principles and their applications. This framework helps nontax specialists see tax savings opportunities and also helps managers to apply tax principles to make better decisions.

To make it easier to use, this analytic framework is called SAVANT. (A savant is an exceptionally knowledgeable person.) This is an acronym for how tax planning fits into business decisions: through Strategy, Anticipation, Value-Adding, Negotiating, and Transforming.

Second, after explaining and illustrating how SAVANT works, we show how managers can apply this framework to typical business transactions. These applications are illustrated with numerous examples drawn from real life in the marketplace. To make them more usable, the transactions are organized around a venture's typical life cycle.

The *value-adding* and *financial reporting* effects of tax management are emphasized throughout the book. Each chapter provides a general discussion appropriate to managers. Greater detail is presented in sections called Tax Management in Action and Technical Inserts.

## **APPLYING SAVANT TO MAXIMIZE SHAREHOLDER VALUE**

SAVANT is used throughout this book to show nontax specialists how to critically analyze situations to generate tax-savings opportunities. SAVANT works as follows: To add maximum value to each transaction, decision makers need to stay focused on the firm's strategic plan, anticipating tax impacts across time for all parties affected by the transaction. Managers *add value* by considering these impacts when *negotiating* the most advantageous

arrangement, thereby *transforming* the tax treatment of items to the most favorable status. Expert managers (and consultants) use these concepts, derived from economic policy and tax law, to maximize shareholder value.

## **WHY MANAGERS NEED TO KNOW THE PRINCIPLES OF TAX PLANNING**

---

Reducing taxes is beneficial, but why should managers learn the basics of tax planning? It may seem obvious at first glance, especially to the owner-manager or corporate entrepreneur. But this is an important question, which can be answered differently at different times, in different organizations, and for operations in different countries.

Managers need to learn about taxes because optimizing a venture's total tax burden is important to its success, and managers are the main decision makers in an organization. Knowing the fundamentals of taxation and how to apply them allows managers to make better decisions and thus be more effective in their jobs. Managers who are able to identify tax issues can also make more effective use of tax consultants, because these managers can recognize a problem when it arises and advise consultants of the trade-offs involved.

Taxes impact success because operational decisions are generally based on the risk-adjusted net present value of expected *after-tax* cash flows. In addition, federal and local income taxes, payroll (e.g., Social Security), sales (e.g., value-added, goods and services, or gross receipts), and property taxes often add up to one of the largest expense items of an organization. Furthermore, tax payments typically have a high legal priority claim on an organization's cash flow. That is, not only can taxes be a big expense, but they also must be paid, and paid quickly.

Furthermore, multinational businesses that are publicly traded in U.S. capital markets can be especially sensitive to tax expense. This is because earnings (which usually have a major impact on stock prices) must be reported on an after-tax basis. Indeed, not only must earnings be reduced by taxes paid in the current year, but earnings must also be reduced by any expected *future* income taxes generated by such earnings. Because senior managers' compensation is often tied to earnings via stock prices (e.g., through stock options), key decision makers in multinational organizations often have a high personal stake in optimizing taxes.

## **SAVANT BALANCES THE BENEFITS WITH THE COSTS OF TAX PLANNING**

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All in all, there are many factors that combine to motivate managers of organizations to seek to reduce taxes, provided the cost of doing so is not

too high. This is because tax planning requires making changes, and doing so is not cost free, nor are the rewards certain. First, the details of taxation are hideously complex. Second, the cost of complying with tax rules (e.g., preparing tax returns and providing details requested by tax auditors) can be significant. Not only can it be costly to figure out how much to pay but also who to pay and when to pay.

Such costs can be particularly high for cross-border activities, which can involve a multitude of different tax jurisdictions imposing different taxes. In addition, similar taxes are often imposed by different jurisdictions using similar but different basic definitions. This raises the specter of multiple taxation (e.g., the same income effectively being taxed at rates exceeding 100%), although governments typically try to avoid this situation through tax treaties and special adjustments, such as the U.S. foreign tax credit.

Finally, although income and payroll taxes may be the province of headquarters staff, and thus savings may not directly affect a divisional manager's annual performance bonus, other taxes almost always do. This is because these taxes are normally charged to strategic business units and thus reduce their individual bottom lines.

Not every idea that saves taxes is a good one. The SAVANT framework helps managers make better decisions because it balances the benefits of tax planning with the costs of doing so.

## **GOALS OF TAX PLANNING**

---

Most people think that minimizing taxes should be the goal of tax planning. This is short-sighted, because taxes are only one factor, albeit a major one, in the mix of costs and other factors that generate the amounts most often taxed: profits and wealth. Put simply, one can avoid many taxes by neither earning a living nor owning property, but most people do not aspire to a life of poverty, however tax free it is. Furthermore, strategies that reduce taxes are rarely cost free. If nothing else, when focusing on saving taxes, managers are not focusing on increasing sales, improving product quality, or producing goods and services more efficiently. The SAVANT framework recognizes this by striving toward *optimizing* taxes, rather than *minimizing* them. The goal is to balance the benefits against the risks and costs.

Tax strategies are also risky: Changing operations to save taxes (e.g., by operating through multiple corporations) often results in an increase in long-term administrative costs and generates uncertain returns because tax laws can change (and, as the past 15 years have demonstrated in the United States, change can occur dramatically, rapidly, and unpredictably), and tax rules themselves are all too often obscure at best.

In cross-border transactions, the interactions of multiple taxes imposed by different jurisdictions also must be appreciated. Also, tax-savings strategies can be intrusive. Why is it, for example, that profitable businesses in the Los Angeles area, a relatively high-tax location, do not all move to Las Vegas, a very-low tax location? One reason is that it is costly to move. Another is that nontax factors dominate the decision: Many business owners simply want to live in southern California rather than southern Nevada. Yet another reason is that skilled labor, qualified subcontractors, and competitive suppliers are plentiful in southern California, as are (perhaps more importantly) customers.

## **GENERIC TAX-PLANNING STRATEGIES**

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Thus, even though total elimination of taxes is not a goal, people and organizations often invest significant amounts of time and resources in implementing tax-reducing strategies. The ultimate goal is to reduce taxes while not excessively intruding on the organization's overall operations. SAVANT explicitly recognizes this.

SAVANT also illustrates that tax strategies are usually based on taking advantage of either the time value of money (e.g., paying taxes later) or differences in tax rates (i.e., tax-rate arbitrage). As already noted, tax arbitrage is typically behind artificial transfer pricing schemes, that is, using accounting entries to shift profits to jurisdictions that impose the lowest net taxes (i.e., the lowest tax costs relative to the benefits received by operating in a particular jurisdiction—e.g., free medical care for all people, including a firm's employees.)

Tax savings strategies usually fall into one of four types: (1) creation, (2) conversion, (3) shifting, and (4) splitting. *Creation* involves plans that take advantage of tax subsidies, such as moving an operation to a jurisdiction that imposes lower taxes. For example, during the past 25 years many engineering and entertainment firms have fled the city of Los Angeles, which imposes a gross receipts tax, and moved to the relatively tax-free city of Pasadena, which is located just a few miles away.

*Conversion* entails changing operations so that more tax-favored categories of income or assets are produced. For example, advertising in order to sell inventory results in ordinary income, which is usually taxed immediately and at the highest rates. However, equally successful *image* advertising generates an increase in a firm's goodwill, which is not taxed until the goodwill is sold, if at all, and then would likely be taxed at lower capital gains rates.

*Shifting* involves techniques that move amounts being taxed (also called the tax base) to more favorable tax-accounting periods. A good example is accelerated depreciation, which allows more of an asset's cost to be a tax-

deductible expense in early years, thus deferring the payment of taxes until later. Another example is an individual retirement account (IRA).

Splitting techniques entail spreading the tax base among two or more taxpayers to take advantage of differing tax rates. For example, the top U.S. income tax rate on individuals is nearly 40%, but the standard tax rate on the first \$50,000 of corporate income is only 15%. Incorporating a sole proprietorship generating \$200,000 in profits, and paying a \$150,000 salary (provided it is reasonable) to the proprietors, is a splitting strategy that saves \$12,500 (i.e., 25% of \$50,000 split off and moved into the corporate tax return) of income taxes each year.

Taxes can also be avoided through fraud, which is fairly widespread throughout the world outside of the United States, but relatively small for noncriminal activities within the United States. Those favoring fraud as a strategy generally need not read books like this.

## **TAXATION: A GLOBAL PERSPECTIVE**

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For many reasons, people and organizations are increasingly operating in multiple locations and competing in global markets. All of these locations and markets have tax consequences that can be managed through proper planning. For example, a California firm may have two manufacturing facilities—one in Ohio, the other in Singapore. The former sells in all 50 states, the latter in Southeast Asia. Federal income taxes will be due on net taxable income from U.S. operations; Singapore, and perhaps other Asian countries to which sales are made, will assess foreign income taxes. Property taxes will be due in Singapore, California, and Ohio; use taxes will be due in many of the 50 states.

How can such a complex tax setting be managed? Not easily. But if every important transaction is guided by critical analysis triggered by the SAVANT framework in conjunction with a periodic environmental scanning, then organization-wide, global tax management will occur.

## **WHY DO YOU NEED THIS BOOK?**

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In sum, taxes can affect the results of a wide variety of decisions, ranging from those made for organizations in which people toil to very personal decisions such as marriage. Sometimes tax considerations are paramount. More often they are important but not dominant. Rather than always trying to minimize taxes, a wise decision maker seeks to optimize tax impacts by balancing expected tax burdens against the costs of reducing them plus the many nontax factors that often are more important in making the best decisions.

Because tax rules are often complex, unclear, and uncertain, even the finest tax experts do not know all of the rules. Instead of trying to help readers learn all of the rules, this book helps managers acquire a critical mass of tax knowledge. Then, using the SAVANT framework, managers can trigger consideration of key tax issues and find and use tax rules to make better decisions in their business, public, and private lives.

Strategic Corporate  
**tax planning**



PART  
**one**

# **Understanding Strategic Tax Planning: A Framework**



# A Framework for Understanding Taxes

*The claim that information would define the future reminded me of the famous party scene in the 1967 movie The Graduate. A businessman buttonholes Benjamin, the college graduate played by Dustin Hoffman, and offers him a single word of unsolicited career advice: “plastics.” I wondered whether, if the scene had been written a few decades later, the businessman’s advice would have been: “One word, Benjamin: ‘information.’”*

—Bill Gates, *The Road Ahead*

**H**ow much are people and organizations touched by taxes? Think about what people do every day. Buy a cup of coffee, and some sort of sales or value-adding tax is almost certainly included in the amount paid. Make a telephone call, and an excise tax is likely incurred. Earn income, and a significant portion of the compensation must usually be withheld for payroll taxes. Make money trading stocks over the Web, and a percentage of the profits will likely be dedicated to annual income taxes.

One conclusion that can be drawn from this thought experiment is that taxes seem to be everywhere, embedded in every transaction. This conclusion can be supported by the following set of simple experiments on the World Wide Web. First, get on a Web browser (e.g., Netscape or Explorer) and run an Internet search on the word “taxes.” Consider the sheer number of hits generated by this simple task. Run the search again on the Web site of a national newspaper (such as [www.nytimes.com](http://www.nytimes.com) or [www.economist.com](http://www.economist.com)). How many articles discuss taxes? Finally, explore one of the gateway Web sites in taxation (e.g., [www.taxsites.com](http://www.taxsites.com) or [www.taxworld.org](http://www.taxworld.org)). As you may already know, a gateway is a Web site that consists primarily of links to other Web sites. Gateways are particularly handy for keeping track of the constant changes in Web addresses and for finding new sites. Be sure to look at the Web site for the U.S. Internal Revenue Service (IRS),

[www.irs.gov](http://www.irs.gov), which was one of the first major sites for a governmental agency and is one of the most heavily used. Browse the various publications available there. How many are there? Other very interesting sites to explore are the U.S. Federal income tax calculator, [www.nettax.com](http://www.nettax.com), and the free tax return preparation site, [www.hdvest.com](http://www.hdvest.com). It also may be worth your time and effort to view the history of taxation found at [www.uic.edu/depts/lib/collections/govdocs/tax/taxhistory.html](http://www.uic.edu/depts/lib/collections/govdocs/tax/taxhistory.html), and the “Hot Topics in Taxation” page of the University of Michigan’s Office of Tax Policy Research at <http://209.69.116.53>.

One reason that taxes seem to be everywhere may be that they are a price paid for government. Not the total price: To some extent (and in many ways, both directly and indirectly), governments support themselves by charging users for specific services provided. For example, some local governments charge a monthly fee to owners of residences that are hooked up to municipal sewer systems. However, throughout the world governments are primarily financed through taxation. Taxes are charges not directly related to goods or services provided, which are imposed on people and organizations located within a government’s legal reach. In many locations in the industrialized world, a multitude of governments and their subdivisions—ranging from cities to nations, school districts to metropolitan rapid transit districts—levy a myriad of taxes on a wide variety of activities, such as income taxes on business profits, property taxes on wealth, value-adding taxes on purchases, and payroll taxes on compensation.

Some taxes are periodic. For example, payroll taxes on employees are usually withheld from each paycheck, and income taxes are typically based on one year’s earnings. Other taxes are generated if and only if certain transactions occur. For example, sales taxes are usually triggered by the retail sales of goods, and inheritance taxes may arise when title to property is passed to a person’s heirs.

The primary purpose of most taxes is to raise revenue to finance governments. But because taxes impose costs on transactions, taxes affect people’s behavior, and thus can (and are) used by governments to try to shape society. Indeed, the primary purpose of some taxes—such as excise taxes on the sale of machine guns, tobacco, and pollutants—is to further social engineering goals.

Taxes seem to be everywhere, and triggered by a bewildering array of activities, but how is strategic tax planning important to people who do not devote their lives to tax consulting?

## **HOW ARE TAXES IMPORTANT IN DECISION MAKING?**

---

Sometimes taxation, and thus tax planning, is one of the most important factors in decision making. Consider the following scenario. Your best friend, who lives in New York City, e-mails you with the news that she has

just inherited a large amount of cash. She asks for your help in investing it in U.S. mutual funds, which primarily hold bonds. Look in a financial newspaper or Web site that shows the current earnings of various bond funds. Pick five at random, and calculate their average yield. Now do the same for five that have the words “tax exempt” or “municipal” in their names. (For the uninitiated, this means that these funds invest primarily in bonds issued by U.S. states and local government agencies. Interest paid on such securities is almost always exempt from U.S. federal income tax, and is often exempt from state income taxes as well.) What is the difference in the average yields of the first set of mutual funds and the tax-exempt set? Could a significant part of this difference be accounted for by tax effects?

Tax planning can affect decision making in even the most commonplace of settings. Consider the case of a typical U.S. homeowner whose annual property tax payment must be paid before January of the following year, and it is now December. Almost all people who pay U.S. federal income tax calculate the tax based on their net income—that is, their taxable revenues less their tax-deductible expenses—in each calendar year. Assume that the property tax is a deductible expense, and that the homeowner is in the 28% tax bracket. This means that every dollar of additional income results in \$.28 in additional tax. Similarly, every dollar of tax-deductible expense saves \$.28 in taxes. If homeowners pay the property tax in December, they will get a tax deduction on their tax returns for the current year. The tax benefit is delayed a year, however, if they wait until January to pay. That is, simply paying this deductible expense a few days earlier generates tax savings a year earlier. This simple bit of planning results in tax benefits through timing, an important component of strategic tax planning discussed in detail throughout this book.

Taxes can even affect the most nonfinancial of decisions. Consider the case of two people who want to get married. Should they be thinking about taxes? Suppose that each will earn about \$30,000 of taxable income for the current year. If they stay single, each would owe a little over \$5,100 of U.S. income tax for the year. Unmarried, about \$10,200 of tax would be generated on their total income of \$60,000. However, if they are married at the end of the year, their total tax bill would exceed \$11,300. That is, the decision to get married would cost them over \$1,000 in U.S. federal income taxes that year. (Note: federal tax liability can be quickly calculated in a variety of ways. One way is to use the tax tables provided by the IRS. These can be found on its Web site at [www.irs.gov](http://www.irs.gov) by clicking on “Forms and Publications,” selecting “Forms and Instructions,” and reviewing “Instructions 1040 [Tax Tables]. Another way is to purchase tax-preparation software or use Web-based programs such as those found at [www.hdvest.com](http://www.hdvest.com) or [www.nettax.com](http://www.nettax.com).)

Reducing marriage penalties like this has been a perennial target of tax legislation during the past few years. Under the Tax Relief Reconciliation

Act of 2001, for example, there are two changes in this area. First, on joint returns—that is, where married couples elect to file one tax return that combines their incomes—the standard deduction (discussed later in this chapter) is being changed. Currently, it is about 85% of that for two single filers. It is being increased to double that of single filers. This is being phased in over a four-year period starting in 2005 and ending in 2008. The current numbers are:

Standard Deduction				
Filing Status	Married Filing Jointly	Single	Head of Household	Married Filing Separately
2001	\$7,600	\$4,550	\$6,650	\$3,800
2002	\$7,850	\$4,700	\$6,900	\$3,925

Two years are shown here so the gradual, across-the-board increases due to inflation indexing can be seen. *Indexing* applies to a variety of, but not all, fixed dollar amounts in U.S. tax law, such as the standard deduction, as well as that rate brackets.]

The second change is that the amount being taxed at the 15% rate for joint filers is being expanded. This is so that the upper limit of amount taxed at 15%—the so-called 15% bracket—will become twice that for single taxpayers, rather than the current 85%. The current rates are:

Tax Year 2002			
Married Filing Jointly		Unmarried	
Taxable Income	Rate	Taxable Income	Rate
First \$12,000	10%	Not over \$6,000	10% of the taxable income
Over \$12,000 but not over \$46,700	\$1,200 plus 15% of the excess over \$12,000	Over \$6,000 but not over \$27,950	\$600 plus 15% of the excess over \$6,000
Over \$46,700 but not over \$112,850	\$6,405 plus 27% of the excess over \$46,700	Over \$27,950 but not over \$67,700	\$3,892.50 plus 27% of the excess over \$27,950
Over \$112,850 but not over \$171,950	\$24,265.50 plus 30% of the excess over \$112,850	Over \$67,700 but not over \$141,250	\$14,625 plus 30% of the excess over \$67,700
Over \$171,950 but not over \$307,050	\$41,995.50 plus 35% of the excess over \$171,950	Over \$141,250 but not over \$307,050	\$36,690 plus 35% of the excess over \$141,250
Over \$307,050	\$89,280.50 plus 38.6% of the excess over \$307,050	Over \$307,050	\$94,720 plus 38.6% of the excess over \$307,050