

WHITE PAPER

Balancing Risk and Reward with Entity Rationalization

*An exploration of the methods and
benefits of optimizing a legal entity
structure*

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► *An Exploration of the Methods and Benefits of Optimizing a Legal Entity Structure*

Traditional tax planning initiatives and the resulting impacts to the corporate entity structure are under fire. Increased scrutiny from taxing authorities and corporate auditors has set the bar for tax planning at a whole new level. To improve tax performance and meet a more stringent set of regulations and other requirements, a new approach to structural planning is needed—one that “rationalizes” an entity structure by examining all possible structural moves and measuring the resulting tax and operational benefits. Fortunately, recent advancements in corporate tax management software are enabling large organizations to optimize complex legal entity structures—enabling them not only to effectively manage tax liability, but also to lower operational costs, improve productivity, and reduce risk.

“The accounting and reporting of income taxes has received increased scrutiny by investors, analysts, Congress, and others. Your auditor will be asking for more information, and you may have noticed an increased level of scrutiny from the SEC staff. That spotlight is likely to continue. Welcome to the new world.”

— Donald T. Nicolaisen
Chief Accountant
Securities and Exchange
Commission
February 2004

Overview

One of the most important responsibilities for corporate tax departments is to bring value to the bottom line by minimizing a company’s overall tax liability. In theory, a corporation’s income tax liability is in direct proportion to its profitability. Because increasing profitability is typically a corporation’s primary objective, reducing tax liability is a challenging necessity.

Traditionally, tax departments have looked to strategic tax planning as a means to achieve this objective. Strategic tax planning often involves adding one or more legal entities as a means to implement the strategy. While this approach has been relatively effective, it has also contributed greatly to the growth of corporate legal entity structures and, consequently, has increased administrative costs and added to the workload of tax departments.

In addition, the passage of the Sarbanes-Oxley Act in 2002 dramatically changed the environment for corporate tax professionals. Beyond competent management of tax expense, tax professionals now have the added burden of more accurately projecting tax liability and documenting the numbers associated with each decision.

At the same time, tight budgets, constrained resources, increasing pressures, and time limitations make structural planning activities even more difficult. To meet these expanded challenges, tax departments need new approaches and methods to project and reduce corporate tax liability while managing tax risk.

This paper will explore a more effective means to “rationalize” the corporate entity structure in an effort to bring value to the bottom line and reduce tax risk for a company in today’s challenging environment. By applying technology in innovative ways, an organization’s tax department will be able to optimize the legal entity structure and consequently lower operational costs and minimize tax liability.

Increased Scrutiny and Regulation Demand a New Approach

A plethora of internal and external pressures are forcing today's tax departments to seek out new approaches and methods to minimize tax liability while managing tax risk.

In the 1980s and 1990s, many corporate tax departments evolved from conservative cost centers focused on tax compliance into profit centers with an eye toward planning. As a result, tax departments were willing to take calculated risks with tax planning strategies—including the addition of legal entities—to minimize a corporation's tax liability, especially corporate income taxes. Once this process started, tax professionals faced continued pressure to continually minimize a company's income tax liability. In many cases, the impact of such pressure led to unwelcome results.

An extreme example of this problem is the well-known Enron case. The seemingly aggressive accounting and tax positions that occurred at Enron, along with the alleged complicity by Enron's professional services firms, sent shockwaves through the business community. Many corporate financial operations, including the tax practice, were placed under the microscope, and what was revealed was not good.

Coinciding with the court of public opinion that turned against the excessive tax practices of big corporations, the court system was dealing with a proliferation of cases involving aggressive strategic tax planning. While acknowledging a corporation's right to manage its business as it sees fit, courts began to place much stricter limitations on tax-saving strategies that lacked a legitimate business purpose. Building on precedents established decades earlier in cases such as *Gregory v. Helvering* and *Frank Lyon Company v. U.S.*, a number of legal decisions were issued that attacked a corporation's right to manage its business, when the corporation implemented a strategic planning approach that had little or no business purpose.

In one of the more notable cases, *Sherwin-Williams* was challenged by several states because the company established a subsidiary for the sole purpose of holding and managing its trademarks, trade names, and service marks. The strategy involved charging a "royalty" fee to other companies also owned by *Sherwin-Williams* for the use of *Sherwin-Williams* marks, then deducting those fees as regular business expenses. Through the use of intercompany charges, *Sherwin-Williams* was able to reduce taxable income in several jurisdictions. Although the company won in one state (New York), it lost in Massachusetts on the basis that the structure did not stand up under the sham transaction doctrine first established in *Gregory*.

Following the precedents set in *Sherwin-Williams* and other similar cases, the landscape shifted. States immediately began to pass legislation designed to eliminate the benefits that resulted from this type of tax planning. In addition, the passage of the Sarbanes-Oxley Act and other recent tax legislation has ushered in a new era for corporate tax departments, requiring stringent internal controls to manage risk. Therefore, while tax professionals continue to be tasked with minimizing a company's tax liability in the face of increasing scrutiny, they are also expected to maintain and provide an unprecedented level of documentation supporting any structural planning efforts. To further complicate matters, organizations have not typically maintained historical data in such form as to effectively defend against attacks by taxing authorities, or to be able to answer corporate auditors when asked "Why was this decision made?"

As a result, tax professionals are “spending more time on compliance, documentation, and disclosure, and a lot less time on tax planning,” says one tax director at a *Fortune 500* company, who estimates she spent 10 times as long on 2004’s annual close as she did in the past. Unfortunately, this shift is likely leading to increased operational expenses, productivity drains, and higher-than-necessary tax liability. A vicious cycle is occurring—more focus on risk management to protect corporate shareholders is reducing the time spent on planning, which in turn is increasing expense and will ultimately reduce shareholder value. To remedy this negative spiral, corporate tax departments need to find a way to strike a balance by performing tax planning in an efficient, low-risk, and highly accurate and transparent way.

The Challenges of Effective Structural Planning

Generally, a company’s legal entity structure has been the result of a series of decisions made over time by corporate executives, driven by acquisitions, business objectives, tax planning ideas, and legal requirements. Unfortunately, this process has often left the company wondering, “How did we get here?”

Not surprisingly, many corporate legal entity structures contain a number of entities that may no longer need to operate separately. Most observers would agree that many corporate structures have become too large and that the resulting associated maintenance costs are too high. In addition, while some of the entities may have been established to reduce a corporation’s tax liability, the overall structure may in fact result in unnecessary taxes. This situation suggests that companies should consider “rationalizing” their existing corporate structure. An effective rationalization process will help an organization identify the *optimal* entity structure to reduce related maintenance expenses and tax liability. However, for a multitude of reasons, it’s sometimes been difficult to get everyone in an organization on the same page when determining the optimal legal entity structure. Why?

There is an inherent bias in most organizations to maintain the existing structure or build on it, if necessary. The reasons for bias vary from one organization to the next, but overcoming this bias has proved to be an elusive foe for many tax departments. For a tax department to identify and implement the optimal structure, they must be able to support their tax planning proposal with a comprehensive impact analysis addressing each move from a tax standpoint. Because of resource and technological constraints, tax departments historically have been unable to overcome this hurdle, and any effort at tax planning has typically added—instead of eliminated—entities to the organizational structure.

Today’s increased demand to manage tax risk is leaving little time for effective tax planning. This pendulum shift could unfortunately generate the negative consequence of increased corporate expense. The key is to find a way to strike the delicate balance between managing risk while minimizing tax liability.

“When you are dealing with hundreds of entities, it isn’t humanly possible to analyze the thousands of possible combinations and estimate the associated tax savings using spreadsheets or compliance tools.”

—Karen Boyaris
State Tax Counsel
Aon Corporation

For most corporations with complex legal entity structures, large-scale efforts designed to find the organization’s optimal entity structure have been virtually impossible. Modeling and analyzing all the possible combinations of entities can be prohibitively complicated, even for a company with just a few dozen legal entities.

“When you are dealing with hundreds of entities, it isn’t humanly possible to analyze the thousands of possible combinations and estimate the associated tax savings using spreadsheets or compliance tools,” says Karen Boyaris, state tax counsel at Aon Corporation, a *Fortune 300* risk management and insurance underwriting firm. “So we would typically test only a few of the most likely combinations—the obvious moves. This clearly was not the best way to make tax decisions.”

This piecemeal approach forces tax departments to “reinvent the wheel,” re-creating spreadsheet models and redoing calculations from a previous quarter or year each time they want to analyze a set of structural moves. This process not only consumes a tremendous amount of time and resources, but because there’s no efficient way to catalog information, it also often leaves a corporation with very little documentation for audits.

# OF ENTITIES	# OF POSSIBLE COMBINATIONS
1	1
2	2
3	5
4	15
5	52
6	203
⋮	⋮
11	678,570
12	4,213,597

Alternatively, tax departments could choose to invest significant dollars to have consultants produce a restructuring study based on a static snapshot of an organization’s entity structure. Unfortunately, there is no guarantee the investment would result in identified savings or that the recommendations would hold up to the inevitable changes in business conditions and corporate requirements.

In addition, in the area of risk management, tax departments have struggled because information and figures that are used for planning are often incomplete or inaccurate, and the tools available for analysis are so limiting that they prevent a thorough analysis of the business situation. Questionable data integrity mixed with limited analysis drives questionable results.

The pressing need to mitigate risk by producing more accurate results in a more transparent fashion has become a very high priority for today’s tax professionals. According to a recent study by Ernst & Young LLP, 44 percent of tax directors say that their companies have become more risk averse in the past two years—with three-quarters of the 354 tax professionals surveyed saying that risk management was now a focus of their performance measurements.

Completing the multifaceted analyses of a legal entity structure to appropriately manage risk has been a challenge for tax directors faced with not enough time or staff to get everything done. This challenge has been further complicated by the lack of sufficient technology to quickly and accurately analyze data and consider all relevant variables—including future-year business forecasts. As a result, tax directors are often forced to conduct planning using only high-level details from critical components of their operation, and then make assumptions about the rest.

While relying on a minimum level of information—combined with a set of assumptions—may have been acceptable in prior times, in today’s environment, those assumptions may be a relatively large number to be considered immaterial, driving a significant level of risk into the decision. For example, say that information used to make a decision consists of approximately 60 percent of the information available for a company with an annual tax liability of \$100 million. Assume further that while the analysis may have proved to be correct, an assumption about \$40 million would represent a substantial number for most corporations—a number that would be considered “material” by most. Unfortunately, this practice of allocating resources to areas of greatest need is simply a fact of life for tax departments that are stretched thin by an increasing volume of work related to compliance. The obvious danger of this reality is that decisions are being made by tax departments that don’t have the ability to consider all of the facts.

For instance, it is not uncommon for an organization to identify a particular strategy that might reduce costs by \$1 million. Then, several years later, a different strategy may be selected that saves \$2 million. It would be easy to assume that the two strategies combined would have reduced the organization’s tax liability and maintenance costs by \$3 million. But that is most likely overstated, as strategies often at least partially cancel one another when overlaid. Further, to avoid attacks from taxing authorities, an organization must be able to substantiate its decisions with appropriate documentation.

As previously discussed, many organizations have sprawling, highly complex entity structures that have been created for various reasons—but many times in a vacuum without careful planning—as a byproduct of individual moves to address specific needs. But, as outlined earlier, determining the optimal legal entity structure using limited data and traditional modeling tools (such as spreadsheets) is virtually impossible, and does not allow for a holistic perspective.

The only way to successfully identify an optimal entity structure is to be able to model and analyze *all* the possible moves within an entire corporation, or at least within a particular business unit. Only then will the tax department be armed with the data needed to overcome the inherent bias in most organizations against reducing or rationalizing the existing entity structure. But unfortunately, because this analysis often involves processing huge volumes of data and calculating thousands—sometimes hundreds of thousands—of scenarios, few tax departments have been equipped to undertake such an initiative.




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Leveraging Technology to Meet Today's Challenges

Technology-driven solutions can transform the tax department into a more efficient, creative contributor that adds significant value to the corporation through highly targeted, well-supported ideas and recommendations. Because powerful computer technology can be used to do the low-value “heavy lifting”—create and run models, crunch unimaginable amounts of data, and provide comprehensive reports and documentation—tax directors and their staffs are now able to spend time on high-value activities such as providing guidance, exploring alternative scenarios, and testing various possibilities.

Changing tax legislation, court decisions, and pressure from stakeholders will continue to increase the pressure on tax directors to manage risk, manage tax expense, streamline compliance, and maintain the appropriate backup for audit purposes. Fortunately, a new generation of software applications is now emerging that provides immediate access to critical data and makes quick work of the most complex modeling initiatives—providing a company's tax and legal groups with the most-promising options for detailed review, discussion, and analysis. These software applications also deliver rich reporting capabilities and full documentation of the decision process for future audit review.



Technology can be used to drive efficiencies into the low-value activities such as data gathering and spreadsheet maintenance, enabling tax professionals to spend more time on high-value activities such as providing guidance, exploring alternative scenarios, and testing various possibilities.

Delivering Technology-Driven Entity Rationalization

One such technology solution is Liquid Engines software, from the company of the same name based in Sunnyvale, California. Liquid Engines' corporate tax management software improves structural planning, auditing, forecasting, and financial reporting, reducing risk by driving greater certainty into the decision-making process, increasing insight into opportunities, and driving efficiency.

The application offers a multi-year, multi-jurisdiction database to provide quick and easy access to tax data, and provides built-in tax intelligence to enable tax professionals to streamline complex “what if” modeling. In addition, the application provides patent-pending entity optimization technology that is designed to measure the tax impact of hundreds—to hundreds of thousands—of legal entity combinations in a few hours, ranking them according to tax benefit. The software allows the tax department to quickly and accurately identify an optimal structure from a tax perspective—offering the data needed to move to a rationalized legal entity structure. In addition, using the software for ad hoc modeling exercises, the tax department can provide the business with a “quick read” on possible mergers or other entity moves. It also offers immediate insight into the potential tax and maintenance cost implications of proposed operational changes such as operational expansion, divestitures, and acquisitions. Further, Liquid Engines' solutions provide full documentation for any structural planning effort—essential on audit or if one or more entity moves needs to be revisited in the future.

“It is no longer possible to complete the analysis on the ‘back of an envelope’ or with spreadsheet-based applications,” says Allan Sutherland, senior vice president of *Fortune 200* company Illinois Tool Works (ITW). “In order to efficiently understand the impact of acquisitions and business restructurings and to plan the optimal tax structure, a strategic modeling solution such as the one provided by Liquid Engines is critical.”

Conclusion

In today’s demanding business climate, prudent tax management is critical to preserving a company’s reputation and maintaining shareholder confidence. Given this reality, tax departments will continue to be expected to manage the delicate balance between risk and reward—to function as a viable profit center while ensuring that senior management has the information needed to make informed decisions in an ever-changing environment.

Unfortunately, traditional modeling tools such as spreadsheets fall well short of today’s requirements to conduct a decision-making process that is rapid, error-free, and auditable. In fact, the typical reliance on spreadsheets—which have proved to be error prone, labor intensive, and limited in scope—often results in the overpayment of taxes, a perilous level of risk, and the underutilization of high-value employees. Limited in both depth and breadth of capabilities, spreadsheets are simply not able to perform all the necessary calculations and deliver reliable information in increasingly tight timeframes. Armed only with spreadsheets, tax professionals will never be able to fully optimize the legal entity structure and reap the associated benefits.

The upside is that the next generation of tax automation is available now—from companies such as Liquid Engines—and can help tax professionals meet today’s rigorous requirements for speed, quality, and transparency. With today’s latest technology, tax professionals are able to overcome the typical entity-restructuring challenges and provide consistently sound ideas and recommendations for optimizing even the most complex legal entity structures, and therefore drive value to the bottom line by managing tax liability, lowering costs, improving productivity, and reducing risk.

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—Allan Sutherland
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For More Information

With Liquid Engines software, a growing number of organizations are optimizing their tax performance by achieving improved efficiency and effectiveness from the tax function, delivering value to the bottom line through decreased entity maintenance costs and tax liability, reducing their compliance burden, and improving risk management.

To learn more about how technology can be used to optimize an entity structure, as well as to obtain further information about Liquid Engines software, please visit www.liquidengines.com, call 408.585.9000, or email info@liquidengines.com.



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