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How Tax Planning Can Increase Your Cash Flow

by JOHN T. CONNOR / National Director—Tax Services

With cash flow problems and fluctuating interest rates continuing to make businesses and individuals alike uneasy about the future, it is still astonishing to discover how little strategic, or long-range, tax planning is being done at the highest corporate level—the CEO. Taxes often are a company's largest expense, readily gobbling up more than half of its earnings. Minimizing that expense by taking an action today that will reduce taxes both this year and in future years, and then making those funds available for a company's operations and growth, is a legitimate and important element of financial planning. An informed and planned use of taxes can yield funds at a lower cost, and it can allow for new acquisitions and for greater emphasis on research and development. Moreover, utilizing strategic tax planning can give executives more time in which to reach the right decisions and can help a business not only to remain competitive but indeed to become dominant.

More specifically, strategic tax planning must address such questions as:

- What is the best form and where is the best place, in the U.S. or abroad, in which to conduct a business, after carefully balancing tax considerations against operating concerns?

- What policies should govern the acquisition of fixed assets, as well as their amortization? Might leasing assets be more advantageous than purchasing them?

- What benefits can a business provide its executives, as well as its rank-and-file employees, at the least after-tax cost?

- And, perhaps, most important of all: what possibilities exist for deferring the recognition of a business's taxable income so that deferred taxes may be used to finance that business?

Following are five examples of how innovative strategic tax planning has helped business executives substantially reduce their taxes.

A Business in Transition

Not long ago, the CEO of a closely held company with approximately $100 million in sales decided to turn the direction of his company over to a new generation and to a professional managerial corps. What the CEO wanted in the decade ahead was to accumulate wealth and to achieve a smooth transition, based on his estimate of the company's growth during that

period. Heretofore, the CEO had not involved himself in the tax policy or tax planning aspects of the business.

The preliminary strategic tax plan that was set up for the executive by his tax consultants was based on the projected rate of growth that he had envisioned. The CEO then realized that because of the impact on the company of taxes he would have less real wealth ten years hence than he currently had. The tax plan that was recommended to him by his advisers proposed the formation of a holding company, an enhanced capacity for capitalization, and a clear definition to the CEO's children and business associates of the company's long-range goals, as well as their own roles in the company. Under this plan, the resulting tax savings were projected to be about $20 million, which would enhance the strength and viability of the organization.

Ad Valorem Tax Study

In a study for executives of a closely held group of affiliated corporations, tax consultants in Tulsa helped to reduce the group's taxable inventory more than $3.5 million by filing a consolidated personal property return. In discussions with representatives of the local assessors office, the consultants obtained consent to change the method of assessing depreciable personal property, an action that further reduced taxable property by $194,000. Through these and other adjustments, the combined property tax savings for one year alone amounted to $152,000.

State Income Tax Study

The widely varying income tax rates and the inconsistency of state apportionment and allocation guidelines can yield significant tax savings. These factors can be evaluated and a state income tax strategy developed to ensure that these inconsistencies will be used to advantage.

For example, when a food processor in the Midwest was expanding its operations, its tax advisers proposed several tax reduction ideas that would result in state income tax savings of about $200,000, if the company's operations could be modified to provide the maximum tax benefits. One suggestion was to shift sales among the states to reduce the sales apportionment factor, as well as to reduce the taxable income in the higher-rate states where production plants are located.

Corporate Group Tax Planning

To minimize federal and state income taxes for a mail-order house with two subsidiaries in Memphis, tax consultants conducted an operational tax review. The consultants toured the client's facilities, met members of the board of directors, and analyzed the group's past income tax returns, as well as various documents and records. Based on this review, they recommended:

- A change from accrual to cash accounting for one company.
- The adoption of the reserve method for bad debts.
- A review of construction costs to identify those that qualify for the investment credit.
- A review of state tax allocations.
- Corporate estimated income tax planning.

When effected, these recommendations will save the three companies more than $1.5 million in income tax.

Foreign Investment in U.S. Real Estate

A group of nonresident aliens from Hong Kong wished to invest in a limited leasing partnership in U.S. real estate that was being promoted as a tax shelter for U.S. citizens and resident aliens. The tax losses and positive cash flow to be generated from this operation would pass through to the investors and thus reduce U.S. taxable income from other sources.

A joint venture was structured for the Hong Kong residents so that they could avoid U.S. capital gains tax on the disposition of U.S. realty investments and minimize U.S. income tax on rental income, while maximizing the share of tax losses to U.S. investors. Under this arrangement, federal estate and gift taxes would be legitimately avoided on the transfer of the U.S. real property investment by the foreign investors. Their tax consultants also suggested ways to minimize U.S. and foreign withholding tax on payments of dividends and interest to shareholders.

These case histories underscore two very important points. The first, of course, is that strategic tax planning must involve decision makers of the highest level within the corporate structure so that planning and policy will be closely linked. To inquire about the tax ramifications of a corporate action after it has been taken is rather like closing the barn door after the horse is gone.

The second point is the importance of strategic planning in focusing on a company's greatest resource—its people. Tax planning is essential if key employees are to build nest eggs to protect their futures. For once they achieve peace of mind about that concern, they can concentrate their creative energies on the company's objectives and its goals for growth.

Despite the reduction in estate and gift taxes brought about by the Economic Recovery Tax Act of 1981, executives still must plan for their own financial futures and for those of their survivors. In response to this need, both large and small corporations will regularly invite tax consultants to attend financial counseling seminars presented for upper- and middle-management people. Some of the topics covered are: net worth analysis, setting objectives, insurance, employee benefits programs, investments, educational financing, retirement planning, and income and estate tax planning.

Conclusion

The role of strategic tax planning in an organization is to augment its cash flow for operations and growth by taking immediate actions that will effect long-range tax savings. Coordinating a client's need for improved cash flow with the tax saving opportunities that are available is the role of the tax consultant, whether seeking to aid the individual, the small company, or the multinational corporation. △