

FEDERAL INCOME TAX
COMPLIANCE COSTS:
A CASE STUDY OF
HEWLETT-PACKARD
COMPANY

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Abstract – *This is a case study of U.S. federal income tax compliance costs at Hewlett-Packard Company (HP), a Fortune 100 multinational company. The paper covers the following topics: (1) resources needed for federal tax compliance; (2) compliance processes; (3) environmental factors, such as financial systems and corporate structure; and (4) reflections on complex and noncomplex substantive areas of compliance.*

HP's experience is that a large U.S. multinational company can complete an accurate corporate tax return with the functional equivalent of three full-time tax professionals. This is attributable primarily to a financial environment with a high degree of worldwide uniformity.

INTRODUCTION

General

This is a case study of income tax compliance cost at a large U.S. multina-

tional corporation. It covers only U.S. federal income tax compliance costs, directly related to the preparation of a ready-to-file Form 1120 and accompanying forms (such as Forms 5471) typical of the filing requirements of a large U.S. multinational.

The paper will focus on the following topics: (1) resources needed for federal tax compliance; (2) compliance process flows and dependencies; (3) environmental factors, such as financial systems and corporate structure, impacting the compliance burden; and (4) reflections on relatively complex and noncomplex substantive areas of compliance.

The study is "anecdotal" as contrasted with a rigorous scientific or statistical approach. In most cases, the data have been compiled by the author, on the basis of his estimates and those of his departmental colleagues. Much of the data come from departmental tracking and budgets and from benchmarking surveys completed by the department. The data are from the company's most recently completed fiscal year 1996 (FY96), unless otherwise stated.

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Hewlett-Packard Company

Hewlett-Packard Company (HP) designs, manufactures, and services products and systems for measurement, computation, and communications. The company's products and services are used in industry, business, engineering, science, medicine, education, and the home in more than 120 countries.

HP ranked number 16 in the 1997 Fortune Magazine listing of the 500 largest U.S. corporations. FY96 revenue was \$38.4 billion. The company has 112,000 employees worldwide.

Hewlett-Packard Corporate Tax Function

HP employs 33 tax professionals in the United States, primarily at its corporate headquarters in Palo Alto, CA. Virtually all federal income tax compliance work is done in-house.

DEDICATED COMPLIANCE RESOURCES

To put these numbers in context, it is instructive to note some key company metrics impacting federal tax compliance. HP has a physical presence (sales and support) in almost every country and manufactures in over 20 countries. It has approximately 100 active operational legal entities (typically one per country), with an additional 30 nonoperational legal entities (e.g., holding or finance companies). The vast majority of these entities are wholly-owned subsidiaries, although there are also several U.S. and international branches and partnerships. Other company-specific factors impacting the compliance effort are described below in the "Environmental Factors" section.

For a company of its size and complexity, HP's outlay on federal tax compliance is quite modest. The full-time equivalent personnel engaged in this activity

are only three. The total amount spent on federal tax compliance is about 13 percent of the total HP Corporate Tax Department budget. It is interesting to note that HP's total costs of local (U.S.) sales and use tax compliance exceed its federal income tax compliance costs. Reasons for these relatively low federal tax compliance costs are addressed below in the "Environmental Factors" section.

FEDERAL TAX COMPLIANCE PROCESSES

The purpose of this section is to provide a high-level overview of the main steps required to prepare a complete Form 1120 with attachments. Time estimates are based on actual time spent rather than elapsed time, unless otherwise stated. For narrative purposes, the entire process can be summarized in the following 12 steps, which are roughly chronological.

Step One: Load and Reconcile Data

Several weeks are needed to process the massive amount of worldwide general ledger data into files that are suited for loading into the tax return software and templates used to prepare the return. For example, general ledger data that are all rounded to thousand dollars must be translated to whole dollars. Processing software is used to reconcile intercompany and other required schedules, and manual analysis is done to investigate material differences. Once the data are loaded into the tax return software database, another reconciliation is performed to ensure that the general ledger trial balances tie to the tax return database.

Step Two: Prepare and Review Schedule M's

240 Schedule M entries are tracked, prepared, and reviewed over the course

of four months elapsed time. The vast majority of these book-to-tax adjustments are temporary rather than permanent differences. Some of the most complex and time-consuming are the following:

- I.R.C. Section 263A uniform capitalization;
- analysis of various book accruals, e.g., restructuring charges, excess and obsolete inventory, and anticipated litigation;
- differences between book and tax depreciation, including the limitation on use of the midyear convention under I.R.C. Section 168(d)(3);
- analysis of purchase accounting adjustments relating to mergers and acquisitions; and
- adjustments resulting from sale versus lease classifications on customer-financed transactions.

Step Three: Collect and Analyze Nongeneral Ledger Data

Although HP has a uniform worldwide general ledger, certain tax reporting requirements necessitate the collection of data that are not available from the normal financial reporting channels. Examples include the following:

- uniform capitalization allocations are based on square footage;
- certain elements of the I.R.C. Section 41 tax credit for increasing research activities are documented by nongeneral ledger allocations of functions between qualifying and nonqualifying activities; and
- foreign income and withholding tax returns and receipts are collected from HP international entities and reconciled to the general ledger.

Step Four: Acquisition-Related Eliminations and Reclassifications

Financial results of acquired domestic subsidiaries may be consolidated into the HP parent company general ledger. For consolidated tax reporting purposes, each of these acquired subsidiaries must separately compute taxable income.

Step Five: Computation of Foreign Affiliates' Earnings and Profits and Foreign Tax Credits, and Subpart F Inclusions

These computations are probably the most complex part of the return. They require approximately one month of work, but, without the use of international tax compliance software, would probably require something on the order of ten times as much time spent. The following is a summary of the required tasks in chronological order:

- determine Generally Accepted Accounting Principles (GAAP) and tax accounting adjustments to international affiliates' earnings and profits (e&p);
- calculate foreign creditable withholding and income taxes.
- update tax and earnings foreign tax credit pools;
- perform look-through computations to determine Subpart F income and foreign tax credit limitation baskets;
- perform *de minimis* and high-tax subpart F exception tests; and
- perform Passive Foreign Investment Company and Excess Passive Asset tests (I.R.C. Sections 1291 and 956A).

Step Six: Preparation of Forms 5471

In order to prepare the Form 5471 information reporting requirements for controlled foreign corporations, it is necessary to determine the following:

- U.S. shareholder ownership interests in each foreign affiliate, to determine if Form 5471 reporting is required;
- analysis of all intercompany transactions involving each reporting entity (CFC), to complete Schedule M of Form 5471; and
- changes in the ownership of all international affiliates, to determine if Schedule O of Form 5471 is required.

Step Seven: Allocation and Apportionment of Expenses

After completion of the steps described above, the allocation and apportionment of expenses pursuant to Treas. Reg. Section 1.861-8 is computed. Much of this task is automated, as expense categories are coded by allocation method, e.g., gross income and cost of sales. The results of this step are (1) foreign tax limitation by basket; (2) basis for Foreign Sales Corporation (FSC) computations; and (3) basis for I.R.C. Section 936 Puerto Rico and Possession Tax Credit. This step takes about two weeks of work.

Step Eight: Calculation of FSC Commission

As one of the nation's largest exporters, HP benefits from the FSC tax incentive. From a compliance standpoint, a Form 1120-FSC must be prepared and, because HP uses the combined taxable income FSC pricing method, the FSC commission must be computed and accounted for on both the Form 1120-FSC and the HP Form 1120 consolidated return. These efforts consume approximately one and one-half months of time.

In calculating the FSC commission, HP groups transactions by product line pursuant to Treas. Reg. Section 1.925(a)-

1T(c)(8). Product line profit and loss statements are reconciled and analyzed as a key step in these calculations.

Step Nine: Calculation of Puerto Rico Tax Credit

HP computes its tax credit for Puerto Rican manufacturing pursuant to the profit split method under I.R.C. Section 936(h). Similar to the FSC compliance effort described above, HP analyzes multiple profit and loss statements based on Standard Industrial Classification (SIC) codes, as a key component of the compliance exercise. Computation of the I.R.C. Section 936 credit takes approximately one month.

Step Ten: Final Computation of Taxable Income

The completed FSC and Puerto Rico computations are then entered back into the allocation and apportionment software module, and final taxable income is computed.

Step Eleven: Disclosures, Notices, and Elections

These return attachments in some cases require substantial compliance effort, although there may be little or no impact on tax liability. The following is a list of the major attachments:

- Section 367 notices for international reorganizations and liquidations;
- notices of foreign tax redeterminations required by Treas. Reg. Section 1.905-3T(d)(2)(ii)(B) (these take approximately one week to prepare);
- disclosure statement (Form 8275) for purposes of the I.R.C. Section 6662 accuracy related penalties; and
- statement of foreign elections pursuant to I.R.C. Section 964.

Step Twelve: Other Miscellaneous Filings

Other return-related filings include the following:

- Forms 1065 for affiliated partnerships;
- filing extensions (Forms 7004 for corporations and 8736 for partnerships); and
- Forms 90-22.1 for foreign bank accounts.

ENVIRONMENTAL FACTORS IMPACTING COMPLIANCE COST

A strong argument can be made that the totality of the particular corporate environment of the taxpayer has as much, if not more, to do with federal tax compliance costs than does the tax law itself. The following 14 factors, while not exhaustive, contribute to an environment at HP that facilitates low federal tax compliance costs:

- (1) one worldwide general ledger and chart of accounts;
- (2) worldwide uniform financial systems;
- (3) credible worldwide GAAP external reporting;
- (4) highly automated tax reporting systems with strong, direct links to the general ledger;
- (5) a company and industry with a tradition of operating in a dynamic, low-cost environment;
- (6) worldwide U.S. dollar functional currency and bookkeeping;
- (7) a company culture in which the Corporate Tax function has credibility and respect;
- (8) a stable, motivated workforce in Corporate Tax and throughout the company's financial community;
- (9) a relatively straightforward organization of legal entities, with a low number of special purpose

legal entities and a simple U.S. consolidated group containing few operating entities;

- (10) company general management at the operating unit level that is not overly incented to care about after-tax results;
- (11) significant effort expended during the fiscal year-end tax provision exercise on obtaining quality tax data, thereby lessening the rework needed during the tax return filing season;
- (12) a federal tax compliance team that strikes a good balance between reasonable accuracy and perfection in putting together the tax return, including tight linkage to the company's federal tax audit process, so that qualitative judgments can be made on filing positions (e.g., the compliance group should be in a position to evaluate whether the prior year's audit settlements should be assumed to carry forward to the current year's return);
- (13) relatively few acquisitions of companies that need to be included in the consolidated return; and
- (14) relatively few complex, unusual transactions that need to be included on the return.

AREAS OF COMPLEXITY

Any consideration of tax compliance cost cannot ignore the role of complexity. As noted in the preceding section, however, environmental factors as well as the tax laws contribute to complexity and cost. In many cases, the line separating these two "culprits" is blurred. Often, the law creates the *complexity*, and the structure of the corporate environment contributes to making compliance *time-consuming*. The following list is representative of

costly compliance areas for HP, because of the complexity of the rules, the time involved in compliance, or both.

- (1) As noted above, strong links between the company's tax reporting systems and its general ledger are an important factor in mitigating the overall compliance burden. Conversely, when those links are absent, compliance costs increase markedly. Whenever data needed for the tax return are not readily available from the general ledger, the manual effort involved in collecting and analyzing the data can be significant. Ongoing, year-to-year efforts in this regard may decline over time as manual workarounds are put in place, but are never as efficient as direct ties to the general ledger. Examples of nongeneral ledger based tax reporting at HP are the following:
 - allocations of costs to inventory pursuant to I.R.C. Section 263A;
 - surveys of internal time spent on capital transactions such as mergers and acquisitions; and
 - product line and SIC code profit and loss statements for FSC and I.R.C. Section 936 purposes. As HP does not maintain its external financial statements on product line or SIC code bases, this is a substantial tax-only reporting exercise.
- (2) The collection, verification, and reconciliation of foreign income and withholding tax receipts, for purposes of meeting the documentation requirements for foreign tax credits, requires substantial time and effort for the company. This is an example where the requirements of the law are straightforward, but the compliance costs stem from the time involved in the documentation effort.
- (3) In a similar vein, the provisions of I.R.C. Section 905(c) and the regulations thereunder, concerning documentation of foreign tax redeterminations, require significant reporting effort.
- (4) The I.R.C. Section 263A uniform capitalization rules are costly to comply with, because, by definition, they require a tax-only method of inventory accounting. This is an area where both the complexity of the law and the documentation effort required contribute to the cost of compliance.
- (5) The computation of the earnings and profits of controlled foreign corporations for Subpart F and foreign tax credit purposes, pursuant to I.R.C. Sections 964 and 902, may require both GAAP adjustments and tax adjustments. Depending on the number of international affiliates and the presence of local country tax resources, doing a perfect job in this area can be virtually impossible.
- (6) Federal tax compliance for newly-acquired companies in the consolidated group presents special challenges. The GAAP financial reporting for goodwill amortization must be reversed and its components individually analyzed to determine proper tax treatment. In most cases, there are a slew of financial accounting adjustments to bring the acquired company's books into conformity with the financial policies of the acquiring company, which, again, must be individually examined through the lens of tax accounting. The acquired company is also

likely to use financial systems that are noncompatible with those of its new parent, making manual adjustments unavoidable. Although these difficulties are generally not attributable to the complexities of Subchapter C of the Internal Revenue Code, they are nonetheless very real compliance costs.

- (7) Tax incentives such as the R&D tax credit and, in prior times, the investment tax credit typically pose compliance challenges, because they incorporate tax-only concepts that may be only tenuously linked to financial accounting principles or to the classifications used by the company's operational units. HP has an annual R&D budget of more than \$1 billion, so it certainly has the financial controls in place to track the spending of those dollars: but is what the company calls "research and development" the same as the "qualified research" eligible for the R&D tax credit under I.R.C. Section 41? The extent of any deviation in those terms is in large part the measure of the compliance costs associated with the tax credit.
- (8) Given the overall size and complexity of the Internal Revenue Code, and the intricate interplay among the many Code sections, it is not surprising that the process of putting together a complete Form 1120 has its own intricate maze. Like the Code itself, there is substantial interplay, and at times even circularity, in the steps of preparing the return. As with most complex processes, many steps must be performed in parallel, and most steps are dependent on the completion of others. For example, Schedule M adjustments and the earnings and profits of controlled foreign corporations must be

completed before the foreign source income limitation can be calculated; the FSC commission computation relies on the allocation and apportionment of deductions; and analysis of book inventory reserves impacts the Section 263A unicap percentage, which in turn is used in calculating the e&p of international affiliates. The list goes on and on.

- (9) Although this case study emphasizes the roles that corporate structure and environment play in federal tax compliance costs, it would be too glaring an omission to ignore the role played by fast-paced changes in the tax laws and environment. We are all familiar with the ever-changing tax legislative scene, but its impact on compliance is not as visible. For example, most large companies rely to some degree on licensed tax return preparation software, whose programmers are constantly challenged to keep current. In some cases (the passive asset provisions of I.R.C. Section 956A is one), the Code section has been repealed before the software has fully incorporated it. Corporate tax planners play a role here as well. For example, most tax return software does not have the capability to deal with hybrid legal entities.

Conclusions

HP's experience is that a large U.S. multinational can complete an accurate corporate tax return with the functional equivalent of three full-time tax professionals, in an elapsed time of five months after fiscal year-end data are available. This is attributable in large measure to a supportive corporate structure and financial environment with a high degree of worldwide uniformity.

